Building on Progress: The Future of Housing Finance in Poland

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LIST OF ACRONYMS AND POLISH NAMES

BGK	Bank Gospodarstwa Krajowego, SA
BGŻ	Bank Gospodarki Żywnosciowej, SA
BISE	Bank Inicjatyw Społeczno-Ekonomicznych, SA
BPH	Bank Przemysłowo-Handlowy, SA
Bud-Bank	Bank Rozwoju Budownictwa Mieszkaniowego, SA
BWR	Bank Współpracy Regionalnej, SA
CDCs	Community Development Corporations (U.S.)
CEE	Central and Eastern Europe
CHF	Co-operative Housing Foundation
CRH	Caisse de Refinancement de Hypothécaire (Bureau of Mortgage Refinance)
CSH	Contract Savings for Housing
DIM	Dual Index Mortgage
EBRD	European Bank for Reconstruction and Development
EC	European Community
EU	European Union
FHLBS	Federal Home Loan Bank System
GBG	Górnośląski Bank Gospodarczy, SA
GBW	Gospodarczy Bank Wielkopolski, SA
GDP	Gross Domestic Product
Gminas	Cities and towns in Poland
GOP	Government of Poland
GUS	Central Office of Statistics
HFPO	Housing Finance Project Office
IGM	The Housing Institute, Warsaw
LGPP	USAID's Local Government Partnership Program
MDA	Municipal Development Agency
MOF	Ministry of Finance
MOJ	Ministry of Justice
MOSEC	Ministry of Spatial Economy and Construction
NBP	National Bank of Poland (Central Bank)
NFOS	Fund for Environmental Protection

NHF	National Housing Fund
PAMBank	Polish-American Mortgage Bank, SA
PBA	Polish Banks Association
PBG	Powszechny Bank Gospodarczy, SA
PBI	Polski Bank Inwestycyjny, SA
PBK	Powszechny Bank Kredytowy, SA
PKO BP	Powszechna Kasa Oszczędności, BP
PKO SA	Polska Kasa Opieki, SA
PLN	New Polish Złotys
TBS	Social Housing Association (Towarzystwo Budownictwa Społecznego)
USAID	United States Agency for International Development
Voivod	Administrative Districts (between the national and gmina levels)

1.1 Introduction

1.0 EXECUTIVE SUMMARY

The primary goals of the housing finance study are to assess the emerging market-based housing finance system in Poland, the legal framework for mortgage lending, and the public finance system for housing and housing-related infrastructure, including the National Housing Fund, the proposed Renovation Fund, the housing allowance system, the Fund for Environmental Protection, and other initiatives guiding public housing policy development. Several key questions have guided the study:

- What policies would help the housing sector emerge from its relatively stagnant position to join in the greater recovery being experienced by the economy overall?

- How will the major new initiatives proposed for private sector housing finance -- mortgage banking and contract savings -- impact existing institutions and initiatives, and what modifications might be suggested to ensure competition, efficiency, and prudent supervision?

- What policies will best increase the involvement of private capital in both market-based and public housing finance?

- What types of public sector subsidies can be most effectively targeted to low- and moderate-income groups and are most consistent with the transition to a market-based system?

Poland is now in the process of developing a comprehensive structure for the delivery of housing finance. Numerous legislative and policy changes have already been put in place or are currently under development. The emerging market-based sector is a uniquely Polish solution, drawing on experience from Poland, Europe, and the United States. The new structure looks to a future in which direct state involvement, with regard both to ownership and funding, increasingly gives way to private efforts, and the capital and financial markets are more effectively linked. Decentralization of rights and responsibilities to gminas has been extensive. These accomplishments are considerable, and many of the building blocks are in place or under development. The challenges now are to consolidate these elements into an overall system for housing and housing finance, and to develop a strategy combining the individual elements into a more cohesive and effective whole.

What is the nature of Poland's housing crisis? Poland's housing production has fallen markedly during the transition period. In 1996, only 54,855 units were completed, which is 18.2 percent less than in 1995. In contrast, 150,000 units were completed in 1989.[1] Rehabilitation, renovation, energy efficiency, and housing-related infrastructure are also major concerns.

[1] Housing production may be somewhat understated at the present time, since housing completions understate housing starts. Nevertheless, there is no doubt that production has fallen during the transition period.

Poland's housing crisis is of relatively recent origin. Comparison of Poland's housing statistics at the beginning of the transition period (1990) with other transition economies and market-based economies with similar levels of per capita income suggests that Poland's housing situation was, in a relative sense, what would be expected. Although comparisons with Western Europe may indicate quantitative and qualitative shortages, Poland was reasonably well housed. This was a result in part of relatively high levels of housing subsidy in the past (measured as a proportion of government budgets). In particular, the housing situation in 1990 in Poland was not deficient as compared with other Central and Eastern European countries.

The Polish economy is now enjoying its fourth year of growth; the rate of growth of real GDP-- 6 percent in 1996 -- was among the highest in Europe. The country has achieved a remarkable degree of transformation toward a market economic structure. Inflation has stabilized although, relative to the needs of the housing sector for long-term capital, inflation remains seriously high.[2] Many sectors are booming: the surge in consumer purchases, such as that of new cars, suggests that the shortage of funds is less than perceived. However, construction of new units is now possibly the most depressed among the comparable transition countries. **Thus, the major "crisis" in housing in Poland is that the sector remains stagnant and has not shared in the strong recovery and growth of the economy overall.**[3]

Why has housing not yet shared in the recovery? While the economy enjoys notable advances, and the volume of bank credit to households has increased, why is the housing sector so stagnant? There is no single cause for the slowdown in housing production. Housing has been caught between "plan" and "market".[4] Both demand and supply factors are involved in the stagnation in housing production. Markets indispensable for housing sector development -- a real estate market; a housing finance sector, solidly supported by market-driven incentives; and effective delivery of land and infrastructure -- have not developed as quickly as other segments of the economy. Poland's housing sector is still in transition from a subsidy and supply-driven approach to one driven by demand.

The slow progress in housing finance and housing construction is perhaps not surprising. In part, this would be expected in any situation of high inflation, depressed real wages, and a declining ratio of income relative to the price of housing, as was evident in the early transition. Thus, even with the assistance of DIMs (so-called dual index mortgages, which seek to increase affordability in an inflationary environment), funds are expensive, and loan-to-value ratios are very low. **However, the relatively slow pace of housing reform and of transformation of the housing finance sector to a competitive, market-based system must also be cited as contributory. Effective housing finance is one of the crucial preconditions to improving housing production.**

Although many sectors in Poland have entered a more mature phase of transformation, **reforms in the housing sector have lagged behind most others**. Relative to many other transition countries, Poland has

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[2] The increase in Poland's real GDP in 1996 was 6 percent. Comparable figures for other Central European countries were: Hungary 0.5 percent; Slovenia 3 percent; Slovakia 6.7 percent; and Czech Republic 4.2 percent. Inflation was 18 percent in Poland in 1996; the comparable figure for Hungary was 20 percent; for Slovenia 9 percent; Slovakia 5 percent; and the Czech Republic 9 percent. (Source: Special Insert to the *Central European Economic Review,* Wall Street Journal Europe, March 1997.) Per capita income in Poland in 1996, as measured in terms of real purchasing power (the purchasing power parity method, PPP) was estimated by GUS to be $6300 -$6350. This is a considerable increase (about 13 percent) over the comparable figure of $5459 in 1995. GUS reports, however, that the Polish figure is only about half that for the poorest nations in the EU and one third of that for Germany, Austria, Denmark, or Belgium. Nevertheless, Poland has made relative gains; in 1993, Poland's per capital income (via PPP) was only one fourth that of Germany's, as noted in Chapter 2.0.

[3] While comparisons with other Central European countries and with Poland's own levels of housing indeed indicate a housing crisis, it is difficult to determine its magnitude. There is no adequate way to chart "what housing production should be" in a transition economy as production shifts from plan to market. As the economy continues its transition, however, comparison with determinants of production in Western economies will become more pertinent.

[4] See Bertrand Renaud, "Housing Finance in Transition Economies."

been slower to privatize the housing stock, slower to raise rents in the public housing stock, and slower to decrease interest rate subsidies. The latter policy has had the effect of allowing the state savings bank, PKO BP, to continue to dominate the sector via a competitive advantage until mid-1995. Thus, Poland has only now made the full transition to market interest rates in the private housing finance sector. Rents remain low, however, stifling incentive for private sector investment in the housing stock. The low rents currently in effect in communal (and other rent-controlled) housing inhibit the participation of private capital from both businesses and households. (Refer to the discussion in Chapter 5.0.)

In addition, there are a variety of outstanding issues that significantly increase **risk** in housing finance. As will be discussed, these risk factors include legal issues (especially the statutory tax lien), administrative problems (in titling and registration, for example), and residual institutional gaps (particularly in supporting skills, such as appraisers and real estate brokers). Improvement in these problems should reduce costs and delays, and thereby stimulate demand. Finally, a variety of **supply factors** and institutional issues still plague housing delivery. Decentralization has left gminas with tremendous responsibilities for land, infrastructure, and housing development. Production of social housing and rehabilitation of the communal housing stock, whether done directly by the gminas or through newly formed public/private partnerships, are still largely gmina responsibilities.

In summary, a wide variety of demand and supply factors have depressed housing production in Poland. Some of these problems are certainly amenable to improvement through changes in policies, incentives, and assistance to gminas. Other problems must await further progress in macroeconomic stabilization and growth in real income.

What are the consequences of a stagnant housing sector? The consequences of a lagging housing sector are serious. A robust housing construction industry has very important **employment and economic "multiplier" effects**. Limited labor mobility and the resultant **labor market inefficiencies**[5] are also very

Box 1.1
Goals of the Housing Finance Assessment

- Provide participants in Poland's housing finance sector with a critical overview of the current status of the sector, including opportunities for, and constraints on, its development;
- Identify the main choices open over the next three to five years to those organizations and institutions which formulate or influence laws and regulations that influence the housing finance sector; and
- Provide USAID with a menu of recommendations for possible technical assistance interventions over the next two years.

serious consequences of a stagnant housing sector. Housing finance is a crucial aspect of an effective real estate market; effective housing finance also forges important links between the financial sector and capital market and brings long-term private capital into the sector. However, the long history of interest subsidies, which are highly distortionary in the context of moving to a market-based system, and the dominance of PKO BP has **limited both competition and access to private long-term capital**. Thus, Poland's growth, relative to its potential, is unnecessarily constrained. In this context, the need for a thorough assessment of Poland's housing finance system becomes more urgent; Box 1.1 summarizes the goals of the assessment.

[5] A recent study suggests that 25 percent of Poland's unemployment is due to the constraints placed on mobility by the rigidity of the housing market (see Coricelli, Hagemejer, and Rybinski).

1.2 Poland’s Housing Goals

As stated by Minister Barbara Blida, the broad goal of Poland’s housing policy is to “create a cohesive economic and legal system capable of generating construction demand.” Many public and private entities are contributing to this goal: the Ministry of Spatial Economy Construction,[6] the Ministries of Finance and Justice; the National Bank of Poland; the gminas and gmina associations; and private and public banks, insurance companies, pension funds, and other domestic and international sources of long-term capital.

Based on our review of the housing finance sector, both public and private, and on discussions with Polish policymakers and practitioners, Box 1.2 presents a framework appropriate for the future evolution of housing finance.

Minister Blida has emphasized the importance, at this crucial turning point, of the “pump priming” impact of budgetary allocations. Unfortunately, the necessity to continue funding of the “old legacy” subsidy policies absorbed over 80 percent of both the 1996 and 1997 housing budgets. This legacy critically saps the Government’s ability to support the new initiatives in public housing finance, including the National Housing Fund and the proposed Renovation Fund.[7]

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[6] During the preparation of this report, the housing policy functions of the Ministry of Spatial Economy and Construction were taken over by the Office of Housing and Urban Development.

[7] Chapter 5.0 provides more information on the legacy of the past subsidy policies. The vast majority of these subsidies represent the cost of government support of the cooperative system. The Office of Housing and Urban Development anticipates that it will be at least seven years until payment for past subsidies is substantially reduced. This is a difficult issue in a context where fiscal austerity is important.

Box 1.2
Proposed Framework for the Evolution of Housing Finance in Poland

Goals of Private Sector Housing Finance

- to increase the supply of housing through greatly increased participation of the private financial sector and the capital market by providing long-term funding, and to support further improvement in the legal infrastructure, safety, and stability of banking and housing finance;
- to encourage competition in the delivery of mortgage loans through both universal banks and mortgage banks -- that is, utilizing both a deposit-funded base and access to capital funds through mortgage bonds -- on an equitable basis for all institutions;
- to integrate the housing finance sector with the capital market and set the stage for secondary market activity through refinancing, securitization, and/or bond financing; and
- to help stimulate savings and housing supply through contract savings schemes and tax and fiscal policies.

Goals of Public Sector Housing Finance

- to encourage the participation of private financing and capital market funding with both national and local efforts to increase the supply of affordable housing, renovate the existing stock, and finance housing-related infrastructure through building private/public partnerships, issuance of municipal bonds, and accessing capital market funding for major public sector programs, such as the National Housing Fund;
- to enhance affordability and the effectiveness of state subsidies, by better targeting and design of subsidy policies to reach the desired segments of the income distribution; and
- to consolidate responsibility for local development at the local level, and to assist gminas in assuming an “enabling” rather than direct role in implementation of their responsibilities regarding housing. This requires integration of numerous goals including rent policy, privatization, capital repair, and the social safety net.

1.3 Summary of Findings

1.3.1 Market-Based Housing Finance

At the present time, the structure of the formal housing finance sector represents a transitional stage in the development of this sector. Midway in the transition from government subsidies to market-based private finance, the sector looks as follows:

- Lending remains greatly dominated by PKO BP.

- Government funds dominate the formal sources of funds; also, as noted, the majority of the government support is not devoted to new projects, but rather represents the “holdover” effects of past subsidy policies.

- The Mortgage Fund has not disbursed at anywhere near the level initially expected, thus depriving the sector of credits assumed to be of very high economic return. (However, this may be more a symptom than a cause of the sector’s malaise.)

Thus, not only is residential investment depressed, but most of it must be financed by "own" resources rather than through credits from banks or government funds. However, important structural shifts are under way. The type of institutional structure necessary to support market-based, competitive housing finance is now being put in place. Promising signs of change include:

- An important new initiative to support mortgage banking is now being addressed.

- A number of banks other than PKO BP have begun to offer mortgage finance, and still others have stated their interest in mortgage lending.

- While the PKO's share of the outstanding balance is still dominant, its share of new loans is falling. Estimates through November 1966 indicate that perhaps as much as 40 percent of new lending originated outside PKO BP.

- Technical assistance associated with the Mortgage Fund -- the work of the HFPO and the demonstration effect of the DIM, for example -- have greatly helped the sector move toward market-oriented strategies.[8]

- Poland's efforts in banking reform, in some ways a model for transition economies, will continue to support the stability of the financial sector.

Chapter 3.0 offers an assessment of the future institutional structure of this sector, new legislative initiatives, the needs of banks now undertaking mortgage lending, the future of the Mortgage Fund, mortgage products, and the role of contract savings schemes.

As noted above, the structure will be a uniquely Polish solution. Ultimately the structure may include universal banks; mortgage banks; capital market funding for mortgage banks, the National Housing Fund, and other entities; secondary market activity, possibly including refinancing via the Mortgage Fund; and contract savings schemes.

As the sector evolves, a number of important structural changes should ensue: not only will the level of residential investment as a percentage of GDP increase, but the share of credit extended by housing finance institutions, especially relative to government support, will increase. Equity provided by households will increase simply as housing activity increases, but will decrease as a proportion of the amount needed to finance a given dwelling. Thus, more households should be able to afford larger housing loans.

Key **conclusions** include the following:

- The transition of PKO BP to a market-rate lender is a positive step toward consolidation of a market-based system. There is encouraging growth in the number of lenders active in, or interested in, mortgage lending. Nearly all these institutions have requested assistance in strategic planning and continued technical training.

- The Mortgage Fund plays an important role in providing liquidity to the sector. In the future, especially if liquidity declines in the face of increased demand, more banks may wish to -- or need to -- participate in the Mortgage Fund. This type of refinancing is not at all inconsistent with the existence of mortgage banks, and may support the participation of smaller institutions.

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[8] Together with the World Bank and EBRD, USAID, through support to the Mortgage Fund and the HFPO (Housing Finance Project Office), has worked to develop the market-based housing finance sector.

- The mortgage banking legislation is a favorable step toward developing capital market funding. However, further assessment of the draft Mortgage Bank Act, with regard to issues such as tax exemption, lien priorities, and supervision, should be undertaken by Polish policy makers, especially with regard to equitable treatment across the entire sector. Many banks have requested strategic assistance; analysis of options regarding mortgage banking is one key aspect of future strategies.

- Contract savings schemes may be a useful addition to the system, but are unlikely to be primary funding sources; their potential demands on the funds of the NHF -- the Government's contingent liability -- should be carefully monitored.

Recommendations

- The development of a system of mortgage banking alongside the universal banks can lead to an effective and competitive system. **However, the "playing field" must be kept level.** All legislative and policy initiatives should seek to maintain equitable treatment. Specifically, there is no reason to favor mortgage bonds over other forms of investment, nor to grant mortgage banks preference with regard to the mortgage lien.

- The German mortgage bond system, upon which the proposed Polish system is based, has a rigid legal structure and a high degree of supervisory oversight. In adapting this system for Poland, policy makers should also undertake a careful assessment of Polish economic conditions, as well as regulatory and supervisory demands.

- The Mortgage Fund should be continued in a new host location. The fund can play a constructive role for depository institutions by providing liquidity and long-term funds.

1.3.2 Legal Issues

Chapter 4.0 addresses the legal impediments to the development of mortgage finance. Transformation from a housing finance system managed by the state to a market-based system has highlighted the need for numerous adjustments to the legal structure reflective of the risks that must now be assumed by private capital and/or market-oriented public financial institutions. The legal structure necessary for housing finance requires the ability to use real property as collateral; clear titling and registration procedures; efficient execution procedures; and the ability to evict after foreclosure.

Poland, like many of its neighbors in Eastern Europe, has made progress in structuring this legal framework; however, a number of legal and administrative issues need further development. Key **conclusions** include:

- The most important legal problem remains the **statutory tax lien.**

- **Registration problems** under the Law on Perpetual Books and Mortgages result in costs and delays, especially because of lack of access to necessary information.

- Other legal constraints include issues concerning the Cooperative Housing Law (unclear legal status of ownership versus cooperative rights, limits on liability, and absence of a Cooperative Transformation Law) and the Condominium Law (lack of legal status of owners' associations and voting requirements for renovation). Consequently, lending to these groups is constrained.

Recommendations

- A study should be undertaken of the relative value to the state treasury of retaining the statutory lien, as opposed to the growth in housing finance resulting from removing this impediment to housing finance.

- As noted above, the **proposed special treatment of mortgage banks relative to universal banks with regard to this lien should be reconsidered.**

1.3.3 Public Sector Housing Finance and Development

Poland is now in the process of developing a fundamentally new approach to public sector housing finance, subsidies, and incentives. A number of important reforms have been passed in the last several years; some of these are already being modified and additional policies are currently under consideration. The delivery of public housing finance funds already takes myriad forms -- subsidized loans, grants, income support policies, tax policies, and technical assistance -- and funds are being put to numerous uses. Two summary characteristics of the new policies are of particular importance. First, Polish policymakers have recognized the need to simultaneously address new construction, rehabilitation of the existing stock, and housing-related infrastructure. Second, they recognize that public funds can ultimately be only a small share of the overall funds required, and thus have aimed many of their policies at various forms of public/private cooperation and inducements for greater participation of private capital.

Chapter 5.0 addresses the key programs in public sector housing finance, including the National Housing Fund and TBS, and other initiatives to develop not-for-profit housing; the proposed Renovation Fund for assistance with rehabilitation and urban renewal; and initiatives directed at housing-related infrastructure, including the Fund for Environmental Protection, and assistance in developing municipal bond funding. The chapter focuses on the national role but also on the all-important role of the gminas in implementing the housing and infrastructure programs, rent policy, and housing allowances.

Major **conclusions** include:

- As noted, the legacy of having to fund past subsidy policies very severely constrains Poland's ability to fund new initiatives. At the current time, the former policies absorb over 80 percent of the housing budget; much of this is due to previous subsidy commitments to cooperatives.

- Formation of the NHF and TBS has created an important new tenure form (not-for-profit) and laid the groundwork for attracting private capital and mobilizing households savings. However, strategies for attracting external funding are not clear and future growth is uncertain.

- The housing allowance program has an unexpectedly small participation rate.

- The major forms of subsidy now utilized are fiscal deductions and subsidized interest rate loans. Tax deductions, since they primarily benefit high income households, are inefficient and regressive. Subsidized interest rates have the potential of being distortionary and/or limiting private sector participation.

- Not all low and moderate income groups may be effectively targeted for assistance with affordable housing. For example, there appears to be a gap between households eligible for housing allowances and those who might participate in TBS-based housing; also, no assistance has been defined for moderate-income home buyers.

Recommendations

- **Gminas should be assisted to play a "guiding role"** rather than a direct role in housing. Capital market funding should be emphasized; thus, ascertaining the debt-carrying capacity of gminas is important. Strategic planning with regard to public/private partnerships, financial management, privatization, and rent policy should be a high priority.

- **Assistance is also required at the local level** to help develop strategies for TBS formation and/or other not-for-profit housing projects. A training and education effort will help develop a cadre of Polish experts.

- **Subsidy policies should be reviewed** with regard to two factors: (1) to determine whether all target income groups are being effectively assisted and (2) to examine gradual replacement of interest rate subsidies and tax breaks with grants and other types of subsidies more capable of being targeted, and/or more consistent with market-based rates.

- **Rent increases** are required to rationalize the maintenance and future-ownership structure of the communal housing stock. These increased rents may need to be supported by expanded housing allowance assistance to maintain affordability.

1.4 Summary: The Future of Private and Public Housing Finance in Poland

Poland is considered by many to be among the "advance reformers" in Eastern Europe. Nevertheless, reforms in the housing sector have lagged behind those in the rest of the economy, contributing to the failure of the sector to break out of stagnation. Now, however, the important building blocks of the future housing finance system are being put in place. Many legislative initiatives and regulations are completed or under way.

These accomplishments are considerable. By the year 2000, both private and public housing finance in Poland are expected to have well-developed institutional structures, emphasizing market-based transactions and links among the financial sector, capital market, and national and local governments.

Based on the current and proposed legislation and the existing institutional structure, there are three basic options for the **future institutional structure of private housing finance:**

- a **depository-dominated system** featuring predominantly if not exclusively the universal banks;
- a **specialized system of lending through mortgage banks** funded by mortgage bonds, or
- a **competitive institutional structure** featuring both **commercial banks** and **mortgage banks,** operating together on a **"level playing field."**

Similarly, there are options for public sector housing finance, mainly revolving around issues such as:

- the ability of public/private partnerships to assume center stage in the production of affordable housing and the renovation of existing stock;
- the ability of major public programs, such as the National Housing Fund and the proposed Renovation Fund, to join private funds with budgetary funds through capital market funding; and
- the ability of gminas to decrease their direct ownership and management of housing and instead engage in policies that enable both not-for-profit and market-based rental and owner housing.

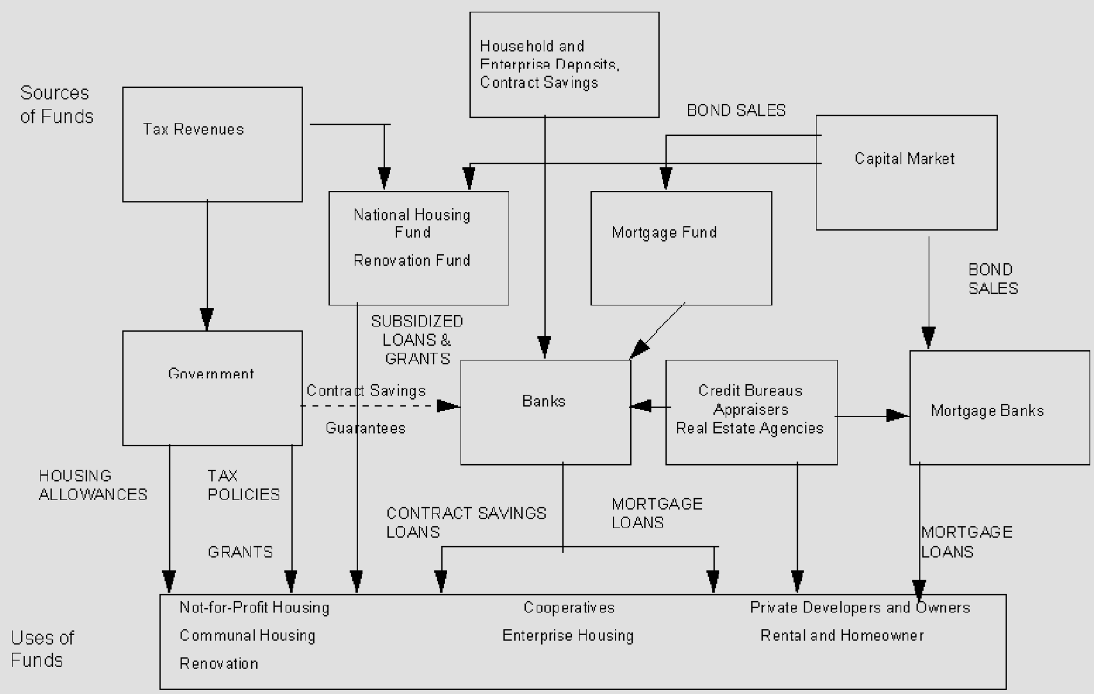
Box 1.3
The Future Structure of Housing Finance in Poland

Poland is developing a uniquely Polish structure of housing finance. It is a pan-European model, drawing on pre-war experience in Poland and Western European experience with mortgage banking and contract savings. In the future, it may be expected that both the universal banks with their broad product lines and specialized mortgage banks will compete fairly on a "level playing field." This structure also reflects the "dual circuit funding" model -- both deposit-based funding and access to the capital market -- which is the hallmark of the United States system of housing finance, and increasingly important elsewhere. Competition will help shape the efficiency and effectiveness of the system. This should be an advantageous structure to support Poland's entry into the European Union and the world financial market.

One possible "future" institutional structure -- private and public -- is presented in a schematic diagram drawn from Chapter 3.0. Figure 3.2 summarizes our preferred scenario for private and public sector housing finance; as is evident, it combines both universal bank and mortgage bank funding and illustrates numerous links between the financial sector, capital market, and national and local government. Please refer to Chapters 3.0

and 5.0 for more detail. For the purposes of this summary, however, a few salient points may be made; Box 1.3 describes the possible future structure of housing finance in Poland.

Figure 3.2
Polish Housing Finance System: 2000



Private Sector Housing Finance. A very likely scenario for private sector housing finance is that it will be carried out by both mortgage banks and universal banks. As evident in Germany and France, the systems are not by any means mutually exclusive, and having both types of systems can facilitate competition. However, it is mandatory that there be a “level playing field” for these institutions, in order to achieve this result. Also of particular importance in this scenario are the additional links with the capital market -- for example, for the Mortgage Fund and the National Housing Fund. The Mortgage Fund continues to play a role in providing liquidity, and contract savings schemes provide supplementary mortgage loans.

Public Sector Housing Finance. In the future, public sector housing finance will rely primarily on the institutions now established or newly proposed for not-for-profit housing, rehabilitation, and housing-related (and environmentally sensitive) infrastructure: the National Housing Fund, the proposed Renovation Fund, and the Fund for Environmental Protection. Two features of the proposed scenario are crucial: (1) the importance of various types of public/private partnerships and financing consortiums to design and fund various projects; and (2) links to the capital market through municipal bonds, as well as those mentioned above.

Policy makers should continue to provide assistance for "fine-tuning" existing and proposed institutions and legislation in order to strengthen both private and public sector incentives and build a cohesive overall strategy. In addition, support should be continued for development of personnel and institutions required for the housing finance sector, the real estate market, and the gminas. These include, for example, Polish business plan analysts, Polish training organizations, and Polish models of effective public/private partnership and financing consortiums.

In the near future, a combination of macroeconomic "pull" and the "push" of improved incentives and initiatives should begin to be evident in housing. Affordability remains a major problem, however. Although real incomes are rising, they remain low by comparison to Europe, and the cost of funds is very high. As discussed below, a rapid reduction in the rate of inflation is probably the single most important improvement that could now be made. However, there are a number of important aspects of the housing finance system itself which need to be improved in order to reduce the cost of funds and improve efficiency. These major new challenges are summarized in Box 1.4. Each of these topics is briefly discussed below.

Box 1.4
Major Challenges to Private and Public Housing Finance in Poland

Housing finance could be greatly improved through:

- a concentrated effort to achieve a more ***rapid reduction in inflation***. As discussed below, this will have multiple payoffs beyond simply a reduction (all-important, however) in the cost of credit;

- a long-term effort to ***improve capital market*** access for both private and public sector housing;

- attention to legislative and regulatory initiatives to ensure creation of a competitive environment and ***"level playing field."*** Universal banks and mortgage banks, for example, should be able to compete under the same circumstances;

- a ***reduction in various risk factors*** -- legal, institutional, and administrative -- that make housing credit less affordable. This will have an important impact on both affordability and the ability to obtain credit;

- increased attention to access to ***affordable housing*** for a range of target income groups; and

- ***modification of certain public housing finance subsidy policies***, to strengthen outreach to a broader set of target income groups, to maximize efficiency in the transfer system, and to minimize possible distortionary effects.

The Macroeconomic Environment: Cost and Risk. As noted, because of its dependence on long-term funds, the housing sector is extremely vulnerable to inflation. The most obvious benefit of reducing inflation is, of course, to reduce the cost of funds. However, fiscal stability will bring other benefits: reduced risk through use of conventional variable rate mortgage products, and a greater opportunity for public sector subsidy programs to switch away from subsidized interest rates to grants and/or market-based loans. DIM mortgage products have provided a useful means of coping with high inflation. The ability to utilize conventional mortgage products -- variable rate or fixed rate mortgages -- will reduce both the risk and the difficulty of marketing complex instruments to new customers. (These products are also easier to securitize should this occur in the future.) Similarly, in the high inflation environment, policymakers have attempted to reduce costs through subsidized interest rate loans. As discussed below, we recommend a gradual switch to less distortionary forms of subsidy, and a lower interest rate environment would encourage that shift.

Capital Market Access. An important facet of mortgage market development, particularly for countries traditionally dependent on deposit-based funding, is the increased development of capital market funding. Not only does this source of funds expand the total flow of funds to housing, it facilitates improved risk management for lenders, an improved allocation of risk in the financial system, improved quality and standardization of the mortgage instrument, and increased competition in the primary mortgage market. The introduction of high quality mortgage securities can stimulate overall capital market development.

Competition and a Level Playing Field. As suggested, it is quite likely, and appropriate, that both universal banks and mortgage banks will offer housing finance. For this to be efficient, it is necessary that there be a level playing field. As noted above, two aspects of the current mortgage banking legislation, tax preferences for mortgage bonds and special treatment regarding lien priority, would give preference to mortgage banks.

Other Risk Factors. In addition to the risk reduction aspects of simpler mortgage products, there are many institutional and legal issues that can help reduce risk, and therefore the cost of funds. As noted, eliminating the statutory tax lien on mortgages would significantly reduce risk to mortgage lenders. Further development of peripheral institutions will reduce the risks associated with underwriting and establishing appropriate loan-to-value ratios; developing more effective real estate institutions will reduce transaction costs.

Affordability. Although some progress has been made in targeting subsidies (housing allowances, for example), there are gaps in the treatment in certain parts of the income distribution, certain policies which could be made more effective, and new policies which might be considered.

The affordability of new housing will remain a problem for some time to come in Poland. For modest income households that are the expected targets of not-for-profit housing, such as that developed through TBS, successful formulas balancing the terms for rents and subsidies have not yet been widely developed. The BGK, with the support of a number of donor groups, is currently addressing this issue; the rent ceiling imposed by NHF may need to be modified and/or the subsidy deepened. For moderate income households seeking to purchase new homes, no direct programs are available; low loan-to-value ratios limit down-market financing. Some relief is obtained through tax policies, but as discussed below, this a not an effective way to target subsidies toward those most in need. Thus, to address affordability for moderate income households seeking to purchase market-based housing, a grant to first-time home buyers and/or tax deductibility for mortgage interest payments might be considered; eligibility could be restricted on the basis of income/family size formulas.

In contrast, for households still subject to rent control, rent-to-income ratios are typically lower than in Europe and in many of the other transition economies. As a consequence, gminas are not able to cover costs in communal housing, and some households may be receiving a subsidy they do not need. **Several policy changes might be suggested to help rationalize these circumstances.** Gminas should be encouraged to increase rents; in turn, the national government should remove (or increase) the ceiling on rent and also liberalize the eligibility criteria for housing allowances (both income and constraints on unit characteristics). Finally, in order to contain the ultimate size of the housing allowance payment, the gap formula should utilize a "prototype cost for an adequate dwelling," rather than actual rent.

Modification of Subsidy Policies. Subsidy systems seek to be efficient, well targeted, accountable, and transparent. It is also desirable that they be as progressive as possible (that is, assistance decreases as income increases), especially when affordability is such a problem. Polish policymakers are accustomed to using two forms of subsidy which do not rank high on these criteria: subsidized interest rate loans and indirect fiscal incentives. Interest rate subsidies are understandable in an environment of high interest rates and severe budgetary pressures; these types of subsidies demand less cash up front than grants, for example. However, an interest rate subsidy approach to assistance is inefficient; it may also be distortionary and thus slow down Poland's transition into a market-based rate environment. Borrowers (TBS, gminas, etc.) may be deterred from seeking market rate loans when provided with interest rate subsidies, thereby reducing links with the private financial sector.

Fiscal subsidies cannot always be well targeted. It has already been noted, for example, that tax exemption of the interest on mortgage bonds interferes with the achievement of a level playing field. In addition, tax exemptions may be regressive (the value of the deduction rises with the marginal tax rate of the investor). Thus, they are not targeted to those with affordability problems and are also not easily accounted for (not explicitly part of the budget process).

In summary then, as interest rates fall (it is hoped) in the future and budgetary pressures (eventually) ease, it is recommended that Poland move toward alternative forms of subsidy, including grants; grants in combination with market rate loans; and/or various systems of matching grants, where the national government matches funds provided by a TBS, for example, or a first-time homebuyer, or an eligible renovation project. To our knowledge, of the major public finance initiatives, only the proposed Renovation Fund suggests the use of grants as one of the subsidy alternatives. This transition will of necessity be gradual because of the immediate budgetary demands, but will serve Poland's goal of increasing capital market funding as well as improved efficiency in incentives.

2.0 POLAND'S ECONOMIC REFORM AND THE HOUSING SECTOR

Is There a Housing Crisis in Poland? Yes, but the situation is complex. To answer the question, one needs both to address Poland's transition from a planned economy, and to compare its housing sector with that of other transition countries and market-oriented counties with similar levels of per-capita income. This chapter presents a summary of these analyses and then indicates the importance to Poland of having an efficiently functioning housing market and housing finance sector.[9] A short answer to why the crisis has arisen involves both economic factors and Poland's relatively slower pace of reform in the housing sector, especially in the early years of transition, as compared with other aspects of Poland's reform program.

The future should (or could) be more promising, however. Many of the major building blocks of Poland's housing reform are now in place or are under active consideration. Two caveats are advisable:

(1) The many new policies and institutions should be considered as a whole with regard to their cohesiveness as an overall structure of private and public housing finance operating in a market-based, competitive manner.

(2) The macroeconomic scenario in the future will continue to play a decisive role in the demand for housing credit; housing finance will only expand as rapidly as macroeconomic conditions, however transformed the institutional structure.

2.1 Macroeconomic Growth-to-date and Status of the Housing Sector

Housing Production. Table 2.1 tells part of the story of the housing crisis. As noted in Chapter 1.0, annual production has fallen dramatically since 1989: from 150,000 units to 54,855 in 1996. In addition, the proposed Act on Renovation indicates that 820,000 units need to be demolished immediately, and a further 570,000 need to be rehabilitated to avoid demolition. Although some observers feel these estimates are too high (having been calculated against a standard more applicable to Western Europe), gmina officials and housing sector experts alike express concern about the need for rehabilitation as well as new construction.

[9] Annexes A and B are published as a companion report. Annex A provides a more complete comparison of Poland with Central, Eastern, and Western Europe, and other countries with similar income (the "income comparators" used in the study). A number of comparisons, particularly during the period 1990 to 1994, are set forth. Data in Annex A and Sections 2.1 and 2.2 above are drawn from Hegedus, Mayo, and Tosics, 1996. Annex B provides a brief statistical overview of the housing sector and the macro-economy.

Table 2.1
New Construction

Developer Type	1989: % of total	1996: % of total
cooperatives	45.1	38.4
communal/enterprise housing	18.3	9.2
individuals/developers	36.6	52.4
Total number of units	150,000 units	54,855

On the positive side, however, there have been important shifts in the mode of production. Together, individuals and private developers constructed 52.4 percent of all units in 1996, up from 36.6 percent in 1989, while the relative importance of communal and enterprise construction declined.[10] Also, although many older co-ops retain much valuable land, discussions with knowledgeable persons suggest that much new construction is being undertaken by smaller co-ops, which act much the same way as private developers. This trend is in conformity with a trend seen in most countries of Western Europe and many countries elsewhere: that state entities assume more of a "facilitative" role and private developers take the lead in construction. (Refer to Annex B, Section 1 for more details on construction.)

Poland's Housing Crisis. In 1990, Poland was not more poorly housed than other countries in Eastern Europe, or market oriented countries with comparable levels of income.[11] From this perspective, a "crisis" in housing -- in terms of both quality and quantity -- simply did not exist in 1990. Now, however, with the rate of new construction having fallen precipitously, Poland ranks poorly among the countries of Eastern Europe. By 1994, the last year for which full comparative data are available, Poland had 296 housing units per 1000 people compared with 397 for the Czech Republic, 334 for Slovakia, 385 for Hungary, and 338 for Slovenia.[12] In contrast to housing, on the other hand, Poland's economy is enjoying its fifth year of overall growth. **Thus, while the economy enjoys notable advances, the housing sector is relatively stagnant.**

After a brief look at Poland's macroeconomic performance, the discussion below attempts to develop some plausible causes for this problem. First, Poland is compared with Western Europe and other countries in Central Europe. The two final sections discuss the importance of housing and housing finance to the economy and suggest important barriers to development of housing finance, emphasizing again the affordability problems caused by high inflation and the importance of recent policy and institutional reforms to housing policy. These reforms are then discussed in detail in the remaining chapters of the report.

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[10] Also on the positive side, recent statistics for the first quarter of 1997 indicate that housing completions totalled 12, 939, up by 20 percent from the same period in 1996. Of this total, 7,421 units, or 57 percent were developed by private investors.

[11] Section 3 in Annex B of the companion report compares Poland with other Central European countries. Although Poland's GNP per capita was less than the average for Central Europe, basic measures of housing adequacy were very similar in 1990.

[12] Please refer to Annex B, Section 3.0.

The Growth in Poland's GDP

In a recent major study of Poland's macroeconomic situation, the economy has been described as one of "fast growth and slow disinflation."[13] The macroeconomic results of seven years of Polish transition are uneven. On one hand, Poland has accomplished the best cumulative GDP growth record of the transition countries. The decline in GDP lasted only two years: 1990 - 1991. In 1992 and 1993, when Poland began its positive increase in GDP, most other countries in Eastern Europe were still experiencing absolute declines (see Annex B). Since 1994, the real purchasing power of Polish households has been rising. The surge in consumer purchases, such as that for new cars, and the increase in the volume of bank credit to households suggests that the shortage of funds is less than perceived. Poland's overall rate of growth in 1995 was 7 percent and exceeded that of every Eastern and Central European country. The growth rate for 1996 is 6 percent, again higher than or equal to most others in Central Europe. Thus, even though many economic problems remain to be overcome in Poland, the growth in GDP has been exceptional.

On the other hand, despite being the first transition country to implement a stabilization program, Poland is not a leader in disinflation. Although inflation is now decreasing each year, the 1996 rate of 18 percent remains quite high and exceeds that of the Czech Republic, Slovakia, and Slovenia.

The Housing Crisis. It is hardly surprising that at the beginning of the transition -- a situation of major restructuring, high and volatile inflation, negative economic growth, and uncertain real income -- that investment in housing would also suffer. However, by 1995, much of the overall restructuring of the Polish economy had been accomplished. Has housing failed to share fully in this restructuring? Why has housing investment in Poland fallen more sharply than in most of the other economies in the region? **In sum, as noted in Box 2.1, it is the contrast between energetic growth in GDP and lagging production in housing that most broadly defines the current housing crisis.**

Box 2.1

- Is there a housing crisis? Yes -- but the situation is complex.

  - In 1990, Poland was as well-housed as other transition countries of countries of similar income.
  - In 1994, Poland had fallen behind all the major central European countries: the Czech Republic, Hungary, Slovakia, and Slovenia.
  - Both housing production and investment as percent of GDP had fallen both absolutely and relative to the other countries.

- Housing production has fallen from 150,000 units in 1989 to 54,855 in 1996.

- In contrast, Poland's recent macroeconomic growth has exceeded that of nearly every Eastern and Central European country.

Thus, the major crisis is that the sector has remained stagnant even as the economy has surged forward.

[13] Refer to Center for Social and Economic Research, "The Financial System in Poland and Trends of its Development," in *Economic Scenarios for Poland*, Centrum Analiz Społeczno-Ekonomicznych, Conference Papers, January 18, 1997, Warsaw. This report presents some results of the research project entitled "The Next Stage of Economic and Political Transition in Poland," coordinated by Prof. Leszek Balcerowicz and Prof. Marek Dąbrowski, the main sponsor for which is the U.S. Agency for International Development.

2.2 The Transition Period and International Comparisons of Housing Conditions and Housing Reforms

The Situation in 1990. In 1990, Poland's housing situation was, in a relative sense, what would be expected of a transition economy with a modest level of per capita income, and a recent history of decline in the growth of real wages relative to the cost of market-priced housing stock. As noted above, Poland was not more poorly housed in 1990 than either other countries in Central Europe or market-oriented countries with comparable levels of income (the so-called "income comparators"). The key findings of this comparative analysis include the following:[14]

(1) **Per capita incomes for transitional economies[15] as a whole were only 1/8 those of Western Europe in 1990 ($2,552 versus $19,792, with Poland at $1,910).** Also, rates of household formation in transition economies (1.4 percent) were only about 1/4 those of income comparators (4.6 percent), although they exceed those in Western Europe (0.9 percent). Household formation in Poland in the period 1990 to 1994, however, was only 0.2 percent. These differences have major implications for a variety of comparative housing outcomes: essentially, potential levels of effective demand in Poland would be lower for these two key reasons.[16]

(2) **Housing prices in transitional economies have been greatly distorted** relative to those in either Western Europe or the comparator countries. First, the ratio of rent to income in the transition countries was lower by about 66 percent to 75 percent. Second, housing prices relative to incomes were more than twice as high among transitional economies. These differences are associated with rent control and non-market production and distribution of housing which resulted in mismatches between supply and demand. **Price distortions in Poland were typical of other transitional-economy price distortions at the start of the transition.**

(3) Despite the evident price distortion, there is **little evidence of a quantitative housing shortage** in the transitional economies based on comparison with market-oriented countries of similar income. Comparisons of households per dwelling, dwellings per 1000 people, persons per room, and floor area per person all indicate that transitional economies fared considerably better in 1990 than did the "income comparator" market-oriented economies. [17]

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[14] These findings are drawn from the analysis in Annex A.

[15] Transitional economies include, in Central Europe, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia; in Southern Europe, Albania, Bulgaria, Croatia, and Romania; and the Baltic states of Estonia, Latvia, and Lithuania.

[16] As another point of reference for Poland during the transition period, recently published data present comparisons of per capita incomes in 1993, as measured with the purchasing power parity method (PPP), for selected countries in Western and Central Europe. Generally, transition economies fare better in comparisons with Western economies when the PPP method is utilized. Poland's per capita income in 1993 was only somewhat less than that for Hungary, but roughly one fourth that in Germany and one third that in most other Western European countries in 1993. (Poland, $4907; Hungary, $5780; Germany, $20,197; France, $18,232; Italy, $16,724; Spain, $12,986; and Portugal, $9638). (Source: World Resources Institute, *World Resources 1996-97*.) As noted in Chapter 1.0, however, Poland appears to be making relative gains; for example, relative to Germany, per capita income in Poland has risen from about one fourth in 1993 to roughly one third in 1996. (Source: GUS.)

[17] Unfortunately, much of the comparison data pertains to Warsaw, which many feel is not typical of conditions elsewhere in Poland. Nevertheless, conditions in Warsaw, for example, appeared to be considerably better in 1990 than in the principal cities of income comparators — with the average household in Warsaw having more than 30% more space per person in terms of floor area and nearly double the space in terms of persons per room compared to households in income comparators. Even the ratio of households per dwelling (equal to 1.10 in Warsaw in 1990, which is often advanced as evidence of severe housing shortage) is below the corresponding figure for income comparators (1.16). Thus, while crowding may be apparent relative to that of the cities of Western Europe (with their incomes in 1990 ten times that of Poland), Poland, and transitional economies in general, do

(4) **Rates of housing production --** which are for the most part driven by demographic change in market economies, but by central decisions on supply in transition economies prior to 1990 -- **were more comparable than currently between Central and Western Europe at the start of the transition.**

(5) **Rates of investment in housing in 1990 were roughly comparable in Western and Central Europe: about 3.7 percent and 3.8 percent respectively.** Investment in Poland at the start of the transition (5.2 percent of GDP) was higher than that of many other transitional economies, in part a reflection of concerted efforts throughout the decade of the 1980s to reduce persistent shortages in housing.

(6) **Rates of private ownership of housing are considerably lower** (an average of 28 percent in cities) in transitional economies than is the case in either the income comparators or Western European countries, where ownership rates are 62 percent and 65 percent respectively. Despite considerable variability in ownership rates in transitional economies, ownership rates in Poland are lower than would be expected (only 6.2 percent in Warsaw and 40 percent for the country as a whole), well below the rate of owner occupation in all transitional economies of 58 percent.

(7) **Housing finance in 1990 was comparatively underdeveloped in the transition economies** relative to the situation in either Western Europe or the market-oriented developing countries. Housing credit relative to all credit (the "housing credit portfolio") stood at about 26 percent in Western European countries, 16 percent among income comparators, and 10 percent among Central European countries in 1990.[18]

The Situation in 1994. By 1994, the year for which the full set of data are available in the comparative study, Poland's relative situation had changed rather sharply. As seen in Table 2.2, housing investment in Poland, as a percent of GDP, had fallen off the most sharply of all the more developed Central European countries. While housing investment fell everywhere in the transition economies, the decline was about twice as steep in Poland. As measured by new construction per 1000 population, Poland's decline was about average; these statistics are compatible because Poland's population is growing very slowly. As a consequence, as measured by housing units per 1000 people, Poland had dropped well below the Czech Republic, Hungary, Slovakia, and Slovenia, as noted in Section 2.1.

well compared to primarily market-oriented income comparators.

[18] Comparisons between Poland and other transitional economies are somewhat ambiguous because of differences in definitions of "housing credit." Data from the first phase of the Housing Indicators Program indicated that housing credit relative to all credit in 1990 stood at only 4.1%. Such a level is indicative of a combination of a large share of owner financing of housing (which is not reflected in lending through the banking system) and government financing in the form of capital grants for cooperative housing and state rental housing.

TABLE 2.2
HOUSING SECTOR COMPARISONS
CENTRAL EUROPE: 1990 AND 1994

	Housing investment as a % of GDP			New construction per 1000 population			Size of new units: m^2	
	1990	1994	1994/1990	1990	1994	1994/1990	1990	1994
Czech Republic	3.2%	2.4%	75%	4.3	1.8	42%	77	87
Hungary	4.2%	2.8%	67%	4.2	2.1	49%	90	101
Poland	5.2%	1.8%	35%	3.5	1.9	54%	77	89
Slovakia	NA	0.2%	NA	4.9	1.3	27%	82	94
Slovenia	4.2%	3.0%	71%	3.9	2.8	72%	93	102
Average	**4.2%**	**2.0%**	**48%**	**3.9**	**1.9**	**49%**	**80**	**92**

2.3 The Importance of Housing and Housing Finance to Poland

Market-based housing finance, drawing on funds from households and other depositors and/or funding from the capital market, is a crucial component in most countries of both the housing sector and the financial sector. Without improvement in its functioning, constraints on Poland's economic growth will continue to be incurred. There are at least four factors to consider in assessing the importance of a well functioning housing and housing finance sector to Poland's economic well-being. A poorly functioning system risks:

(1) failure to capture important construction multiplier effects;
(2) price distortions and supply shortages, resulting in lack of labor mobility;
(3) a related failure to modify the course of urban development in transition economies, especially the spatial layout and the growing importance of the urban sector; and
(4) failure to establish a key two-way link between the capital market and housing finance based on the utilization of long-term capital.

All of these factors are relevant to the well-being of any economy. However, **in the context of transition economies, they take on special meaning**, particularly because of the need to switch housing construction and rehabilitation from a central command structure to one propelled largely by market demand, and also because of the need to spatially revamp channels of urban growth.[19]

[19] In response to distortions inherited from the previous system, some observers feel that in comparison to the spatial structures of cities developed in the context of market-based signals, the geographic distribution of dwellings in large transition cities may not be responsive to current demand, nor is placement of industrial and/or service activities necessarily reflective of Western cities. See, for example, W. Jan Brzeski, "Developing Mortgage Finance in Poland's Transforming Economy,"

Construction Multiplier Effects. Depressed housing sector activity will deny the economy at large the important "multiplier" effects of a dynamic construction industry (for example, the phenomenon whereby one job in the construction sector generates additional spending, and thus jobs in related sectors such as building materials, plumbing and electrical work, technical fittings, and furniture). Many studies have been done in different economies to determine the magnitude of the multiplier effect of employment in the construction industry. Some analysts hold that construction ranks fourth among all industries. Whatever the exact rank, the employment impact has been proved to be an important one.

Price Distortions, Housing Shortages, and Limited Labor Mobility. Price distortions stemming from shortages in new construction, due to lack of credit and other factors, will not only impact the affordability of single family homes, but will also have a severe disincentive effect on private rental housing, which is less easily self-financed. The supply shortages and price distortions will be propagated beyond the housing market to the labor market. Thus, ultimately, the lack of mobility in the labor force will slow down growth. As noted in Chapter 1.0, a recent study has concluded that as much as one-fourth of Poland's unemployment rate is attributable to constraints on the mobility of the workforce caused by the rigid housing market. Thus, the growing housing shortage will increasingly constrain Poland's ability to restructure its economy -- the industrial, service, and agricultural sectors. To the extent that this further slows down growth in the share of GDP generated by the private sector, productivity will also suffer.

Finally, rehabilitation and renovation of the housing stock is a serious issue in Poland, as further discussed in Chapter 5.0. Lack of credit for **rehabilitation finance** will exacerbate the rehabilitation problem by adding to downward pressure on housing quality, if normal wear and tear is not remedied in a timely fashion. If, in the long-term, lack of rehabilitation leads to an increase in the need for demolition, a vicious (downward) spiral has been unleashed in housing supply.

Urban Development in Transition Economies. Closely related to the point above, lack of urban labor mobility has a special detrimental effect by mitigating the natural role of the urban economy as an engine of growth. In the housing policy debate, more attention should be paid to the linkages of housing to the national economy through its impacts on urban productivity and redevelopment. Much has been written on the problems facing transition economies stemming from the lack of properly functioning land markets and inadequate urban strategies.[20] Economic growth in urban areas in Poland is providing a strong stimulus for the urbanization process, which is extremely important in a country where one third of the population is still agrarian. Housing finance provides the mobility of real and financial capital vested in housing assets, without which this process will falter. The necessary migration from rural to urban areas (as the share of sectoral activity in agriculture declines and that in industry and/or services increases) will be greatly hampered by lack of housing.

The Growth and Maturation of the Capital Market. This is probably the single most important and direct link of housing finance with economic development. The growth and maturation of the capital market will not proceed fully unless housing finance is fully integrated into the banking and financial sectors, and they in turn are integrated into the capital markets. The growth and maturation of the capital market and its link to housing finance is an important issue in all countries: transition economies, developing economies, and mature economies alike.

Prior to the transition, housing finance in Poland was considered simply a form of subsidy, and measured almost entirely by the level of housing spending in the State budget. While this view of housing finance has

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Housing Finance International, Vol. X, No. 3, March 1996; and Bertrand Renaud, "Cities Without Land Markets, Lessons of the Socialist Experiment," World Bank Discussion Paper 227, 1994.

[20] See the articles cited in the previous footnote.

gradually eroded, it is important that a broad view of the macroeconomic importance of the housing sector take its place. As discussed in the remainder of the report, the emergence of the capital market as a source of long-term funds for housing and the participation of private sector capital in housing is crucial both for funding housing and for assisting development of the capital market. This is very much an “inter-dependant” phenomenon. Housing finance requires long-term capital to develop, for reasons of both liquidity and risk. On the other hand, mortgage bonds, municipal bonds, or other types of capital market funding such as might occur through the NHF, for example, can provide a newly developing capital market with secure, long-term instruments that provide excellent alternatives to government paper. **In sum, there is an important two-way street between the development of long-term capital markets and the growth of investment financing as a means of funding not only market-based housing, but also the not-for-profit housing sector and infrastructure.**

2.4 Barriers to the Development of Housing Finance and the Housing Sector

Economic Restructuring. Poland has achieved a remarkable degree of transformation toward a market-based economic structure. Poland was one of the first countries (if not the first) to undertake a broad set of market reforms, and the country has now entered a more mature phase of transformation. During the first half of the 1990s, however, the initial years of radical reform were followed by successively slower changes. Poland began with macroeconomic stabilization and the restructuring of basic sectors, including the banking sector. This was followed by major investment in national infrastructure such as railways, ports, highways, and energy, and followed more recently with local infrastructure, such as urban sanitation. However, **economic restructuring of Poland’s housing policies has not kept pace with other reform initiatives; as a result, the housing sector is just emerging from a transition period -- the sector is now poised to move from a subsidy and supply-driven approach to one driven by private capital and demand.**

2.4.1 Barriers in Development of Housing Finance

What have been the major barriers to the advancement of housing finance in Poland? Several factors, stemming both from Poland’s current economic condition and the unevenness of its housing reform policies, have depressed both the demand for, and the supply of, housing: (1) the high cost of credit; (2) the relatively slow pace of housing policy reform compared to other restructuring initiatives in the economy; and (3) the legacy of past subsidy policies on limiting the extent to which State funds can provide a push to needed programs. Each of these topics, summarized in Box 2.2, is discussed below.

Box 2.2
The Causes and Consequences of Stagnation in the Housing Sector

The major causes of the crisis are:

- Limited demand, stemming from:
  - unfavorable macroeconomic conditions;
  - high cost of funds; and
  - limited public sector assistance.
- A slowdown in housing policy reforms:
  - subsidized lending ended only in mid-1995; and
  - rent controls inhibit privatization and development of a private rental market.
- Legal, administrative, and supply constraints.

The major consequences of a lagging housing sector are:

- failure to achieve important multiplier effects from construction activity;
- constraints on growth and restructuring of the economy stemming from limited labor mobility;
- failure to fully harness urban development as an engine of growth; and
- most important, failure to maximize links between the financial and capital markets.

(1) An Economic Environment not Conducive to Demand for Housing. A lengthy discussion of Poland's economic situation is certainly not a main objective of this report. There are major reasons, however, why economic conditions must be stressed in the context of a transition into a market-based housing sector primarily supported by private sector funds:

- The demand for housing is very much a function of **"permanent" income:** that is, the long-term expected value of one's income. The combined effects of high inflation, uncertain income, and uncertain employment will thus greatly depress demand.

- In the transition from an environment of subsidized loans to one of competing for private long-term funds, the **cost of credit assumes a strategic importance** it did not previously have.

- Correlated with the impact of reduced cost, **fiscal stability** will allow greater use of simpler mortgage products and an opportunity for the public sector to retreat from subsidized loans (and their possible distortionary impact on sector development).

Despite its strong growth overall, serious economic problems remain. Poland's unemployment rate remains high; at 12.4 percent in the second quarter of 1996, the rate exceeds that of Hungary, the Czech Republic, and Slovakia. As noted above, inflation remains high -- at 18 percent in 1996 --

which prompted the president of the NBP to warn that the Government's target of 13 percent for 1996 had not been realistic.[21]

Poland's creative work in developing and implementing dual index mortgages (DIMs) represents an appropriate and innovative response to the problem of inflation; yet ultimately, **unfavorable macro-economic conditions**, specifically the **high cost of credit for long-term funds**, will depress the demand for housing, probably more than any other single factor. The sensitivity of housing demand to the cost of funds has been the topic of countless studies in Western Europe, the United States, and elsewhere. The estimated parameters of these studies (for example, the quantitative impact of level of interest rates on demand, with other variables such as income and household characteristics taken into consideration) certainly cannot be "imported" directly into Poland. This is not only because the transition situation is rather unique, but also because each country's profile of cultural factors and housing stock is unique. Nevertheless, it can be assumed that the severity of downturns in demand experienced elsewhere, due to marked increases in the cost of funds, have some merit in describing the current situation in Poland (downturns in the housing sector were quite severe in the United States and United Kingdom in the previous two decades; inflation and the high cost of credit were important contributory factors). Conversely, we can expect that a reduction in the rate of inflation, and hence in the nominal cost of credit, will increase demand for housing.

(2) The Impact on Government Spending of Pre-Reform Subsidy Policies. The **housing budget dilemma** in the transition period is the legacy of past subsidy policies. As has been noted, Minister Blida recognizes the utility of focused public expenditures to assist not-for-profit new construction and rehabilitation; however, the funds available to finance new programs are but a fraction of payments for previous subsidy policies. The outcome has been to concentrate on fiscal incentives, which are not always targeted to those most in need (that is, low income households generally cannot benefit directly from tax incentives).

Under the type of economic circumstances facing the housing market, Poland is correct to call for targeted fiscal incentives to assist housing. The Government, however, is greatly constrained by the large share of the budget for housing -- about 85 percent in 1996 and 1997 -- that must be used to pay off old subsidies rather than assist new projects (refer to Chapter 5.0 and Annex B). For example, from a total budget of just over PLN 4 billion, PLN 1.22 billion was required for purchase of accrued interest, PLN 1.2 billion for refund of interest on home savings accounts, and PLN 634 million for subsidies connected with cooperative development. In contrast, only PLN 120 million was available for the National Housing Fund (to encourage formation of TBS and the not-for-profit rental sector and to support renovation and/or infrastructure). The new Office of Housing has estimated that it will be roughly seven years before the impact of the old legacy is largely diminished.

New housing has been more strongly supported in 1996 through various fiscal policies: the VAT on building materials is 7 percent instead of 22 percent. Housing investment up to PLN 64,000 is deductible from taxable incomes (with the highest incomes subject to 45 percent tax rate). These two major bonuses were applied to all housing investments under way in 1996. Informed experts estimate that the resulting yearly tax savings could represent respectively up to PLN 0.5 and 1.5 billion. Capital gains taxes represent 10 percent of resale values (void after 5 years of residence, or if sums are reinvested in housing within one year).

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[21] Economic observers in Poland cite a number of reasons for the high inflation rate: monetary policy, interest rate policy, and exchange rate policy. In particular, a high budget deficit, rapid expansion of credit to households and corporations, poor inflation forecasting, and lack of full independence of NBP are all cited as contributory. Another reason may be Poland's effort to build up depleted foreign exchange reserves to pay off the large foreign debt; devaluation of the zloty relative to other currencies results in making imports more expensive (which raises prices), and growing reserves add to the money supply. See *Economic Scenarios for Poland*, op. cit.

(3) The Slow Relative Rate of Reform in Housing Policy. The moves to market, attendant with the first phase of the transition, have been highly uneven among the Eastern European countries (refer to the discussion in Annex A). Poland represents an example of more modest change than that of many other countries in the region, especially as regards privatization and rent price reform, subsidy restructuring and targeting.

The slow rate of policy reform in the housing sector, relative to other restructuring undertaken by Poland, has had a number of impacts. It discouraged the entry of banks (other than PKO BP) into the sector and thus limited competition in offering housing credit. This, in turn, retarded the acceptance of market rate mortgage products. Interest rate subsidies, after being discontinued in 1992, were then reinstated and were not discontinued again until March 1995. **Further, the slow change in rent control policies has discouraged more rapid privatization of the communal housing stock and has also reduced incentives for development of a private rental market.** As noted, rent-to-income ratios are particularly low in Poland as compared with countries of comparable income, and even with some other Central European countries.

These factors have restrained the sector from playing as full a role as might be possible in the ongoing process of economic reform. Since the availability of mortgage credit was previously limited to PKO BP, effective competition from other banks has only just now emerged. Further, if interest rates are subsidized, there is no incentive for private capital to fund housing. If, for example, the Mortgage Fund were to receive a state subsidy, its participants would benefit to the detriment of non-participants, and the incentives to pursue the introduction of mortgage banking (at market rates) would be weakened. Also, if public rental housing is subsidized through price (rent) control, there is no incentive for private capital to invest in private rental housing, nor is there any incentive for standing tenants to move and forgo their subsidy. In the latter situation, a subsidy is also being given to those who can afford to pay, as well as those who need assistance, so the utilization of Poland's capital resources becomes less efficient.[22]

Thus, while it might be argued that in some countries of the region some housing reforms have gone too far, too fast (as in the case of massive privatization without adequate condominium laws or provision of residual "safety net" public housing in countries like Romania and Lithuania), in Poland the situation has been more one of not far enough, or too slow. The reasons for this are complex. Often, enabling legislation has been passed but not implemented, or considered but not passed. In addition, local authorities were expected to quickly take on immense new responsibilities for making and implementing housing policy and for administering public housing. Although difficult social issues must be addressed, the benefits of a faster pace of reform appear to far outweigh the costs of a slower pace. As we discuss in this report, many of these issues are now being rectified.

2.4.2 The Next Crucial Steps in Reform

What needs to be done? The responses to these problems, briefly summarized below, represent the key topics developed in the next three chapters of the report. Summaries of our findings and recommendations can also be found in Chapter 1.0. Chapters 3.0 to 5.0 present the following discussions:

- **Chapter 3.0 discusses private market housing finance and the recent major steps in institutional development. Consolidation into an equitable, consistent, and competitive structure should be a priority.** Both competitive lending institutions in market-based housing

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[22] It should also be noted that for policy reform initiatives for the economy as a whole, Poland apparently lost some of the momentum exhibited in the early years. Thus, over the period 1990 to 1995, the share of GDP originating in the private sector continued to increase, but relative to other transition economies it fell. The share of private sector GDP went from the highest level of all reforming economies in 1990 (28 percent) to only the seventh highest in 1995. Observers suggest that much of this stems from a slowdown in enterprise privatization and restructuring; the drain still caused by some enterprises is an important element in the failure to decrease the budget deficit and thus inflation. See, for example, Barbara Błaszczyk, "Privatization in Poland: Accomplishments, Delays, and Things To Do," in *Economic Scenarios for Poland*.

finance and the supporting components of a real estate market are important. Chapter 3.0 discusses recent efforts to introduce mortgage banking into the sector, and to spur savings for housing through contract savings mechanisms. It also discusses a continuation of the Mortgage Fund, or an alternative institutional structure for liquidity and/or secondary activity.

- **Chapter 4.0 discusses the legal and administrative structure necessary to support** mortgage lending and efficient transfer of property.

- **Chapter 5.0 discusses policy reform in public housing** finance and transformation of the structure of public housing finance and housing subsidies to a largely **public/private partnership structure**, necessary for the development of incentives for private sector participation, especially in the rental sector, but also for the efficiency and "private capital leveraging" effects of a well-structured public program. Continued reform in rent, privatization, condominium, and housing allowance policies are also discussed in Chapter 5.0.

In closing, two fundamental structural elements are emphasized throughout these three chapters: (1) the development of **strong capital market linkages** for both private and public sector housing finance, including **effective incentives and mechanisms** to bring private capital into the housing market; and (2) **attention to the continued transition to market-based housing policies.**

In the last several decades, the United States, many countries in Western Europe, and other countries have increasingly introduced competition into the housing finance sector. The so-called "special circuits" which separated housing finance from the broader financial sector **--** and supposedly gave it a competitive and/or affordability advantage in this manner **--** are being dismantled. The reasons vary, but failure to entice private capital into the sector, "moral hazards" arising from the special privileges, and lack of competition are key among them. As a result, more and more countries are turning to **market-rate financing** of housing and **dual financing circuits --** one based on depository institutions and another based on effective access to "wholesale" funds from the capital market. Also, Western countries that have had public sector ownership of large shares of the housing stock are increasingly **privatizing the stock** and turning to the private sector to manage the remaining share.

> Box 2.3
>
> "Poland's transition process needs a new push forward. This concerns all its aspects -- privatization, deregulation, institutional reform, microeconomic restructuring, and macroeconomic policy. In the last area, bigger progress in curbing still-excessive inflation is of key importance for the prospects of economic growth and smooth accession of Poland to the EU. If the central bank and Government do not succeed in this respect, Poland will face the danger of long-term economic stagnation and 'second class' membership in the EU."

It is along these paths that Poland has begun and should continue. Box 2.3[23] presents an overview of reform goals for the entire economy, all of which are as important to housing finance as to economic growth overall. **Implementation of these recommendations would indeed be supportive of housing finance.**

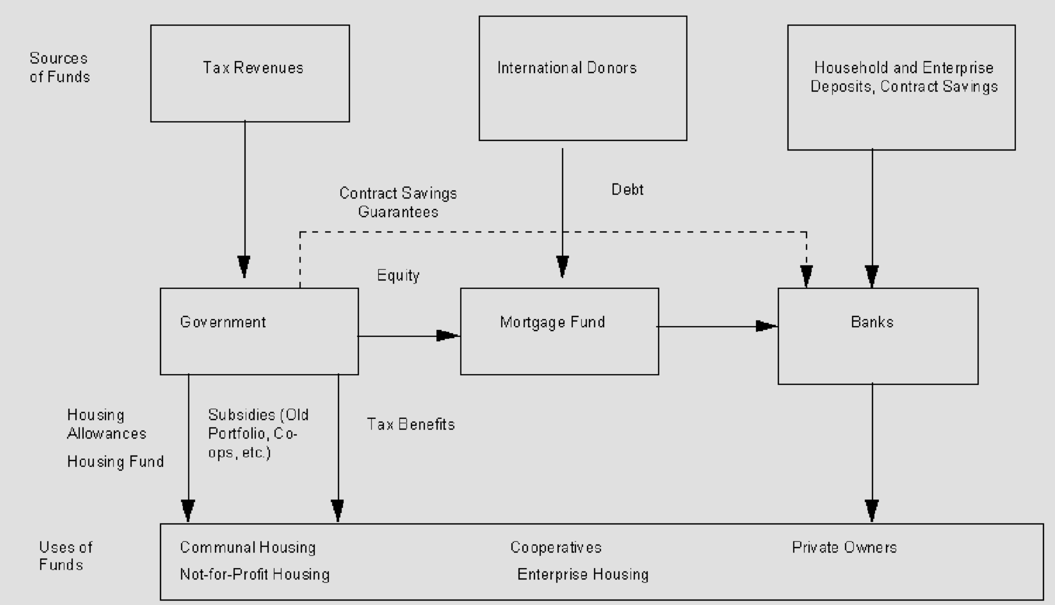
[23] Quoted from Marek Dąbrowski, op. cit., p. 13. In the same report, see also Sławomir Lachowski, "The Model of the Policy Financial System Conducive to Maximization of Long-Term Economic Growth."

3.0 THE EMERGING HOUSING FINANCE SECTOR IN POLAND

3.1 Structure of the Housing Finance Sector: Overview

The housing finance sector in Poland, as a result of reforms to the financial sector overall as well as those specifically directed to housing policy, is now developing an institutional structure more appropriate to the continued development of market-based lending. As shown in Figure 3.1, mortgage and other housing loans are now being made by a number of banks. They obtain their funds primarily through deposits and secondarily from loans from the Mortgage Fund, which acts as a liquidity facility providing long-term funds to lenders with loans from international donors (World Bank, USAID) and funding from the Government of Poland (GOP) in the form of equity contributions. **Bud-Bank,** a state housing bank, administers the Mortgage Fund.

Figure 3.1
Polish Housing Finance System: 1996



At present, the structure of the housing finance system clearly represents a transitional stage in development of this sector:

- Housing finance loans from the financial sector are still limited, both in number and through low loan-to-value ratios; a large share of funding for housing comes from households and developers, rather than being provided by bank credits.

- Mortgage lending remains dominated by PKO BP; however, in 1995 the PKO shifted from subsidized to market-rate loans.

- The majority of the government support is not yet devoted to new projects, but rather represents the “holdover” effects of past subsidy policies. The National Housing Fund, established in part to assist development of not-for-profit housing, has not yet established a steady flow of funds to eligible projects, and other initiatives, such as the Renovation Fund, are still in the proposal stage (see Chapter 5.0).

The government also provides support to the sector in the form of tax incentives. As noted in Chapter 2.0, informal estimates suggest that tax breaks on housing investment may have amounted to PLN 1.5 billion in 1996. Finally, together with the gminas, the government supports affordability via the housing allowance program. However, although the Government housing budget for 1996 was PLN 4 billion, over 85 percent of these funds are required to pay for earlier subsidy policies (see Chapter 5.0 and Annex B). The major subsidies which must be paid off are:

- purchase of interest from the old housing portfolio (mostly PKO BP until 1995);

- the refinancing of interest premiums of saving housing books; and

- subsidies to cooperatives.

This very large burden should gradually decline with time, but leaves few resources to support new projects.

The Future of the Formal Housing Finance System. The development of the housing finance system in Poland has reached a critical phase. The key question is along what lines the sector will develop. As noted, the type of institutional structure necessary to support market-based and greatly expanded housing finance is now being put in place. The key new pieces of legislation are to introduce mortgage banking and a contract savings system.

Three scenarios, presented in Box 3.1, are analyzed at length below in Sections 3.4 and 3.6, as is the Mortgage Fund (Section 3.3) and the recently introduced contract savings system, which is a supplementary, government-supported housing finance system (Section 3.5). The goals articulated in Chapter 1.0 for private sector housing finance -- increased participation of the private sector and capital market; competition on a level playing field from both universal banks and mortgage banks; provision of liquidity through refinancing, mortgage bonds, or other secondary market activity; and stimulation of savings for housing through contract savings and other means -- are reflected in the discussion which follows.

Box 3.1
Future Scenarios for Market-Based Housing Finance

There are essentially three principal scenarios for the future: (1) continuation of the existing structure, a depository-dominated system that receives supplemental capital market funding through the Mortgage Fund (or a variant thereof); (2) a new mortgage banking system funded primarily through the capital market; and (3) the co-existence of both of these systems -- so-called dual-circuit funding -- in a competitive and equitable environment.

The key to the development of a market-based housing finance system is access to the capital markets. Currently, there are no major institutional investors financing housing. As these types of investors, typically life insurance companies and pension funds, become more important in the financial system, mechanisms must be developed to channel funds into housing. Investors with long-term funds provide an ideal source of financing for durable housing assets. Figure 3.2 (found at the end of the chapter) represents the future structure of the system, where both universal banks and mortgage banks operate in the market, obtaining funds from deposits and the capital market, and the role of the government becomes supportive in terms of policy, but subsidiary as a source of funds.

Box 3.2
Signs of Change in Housing Finance

- A number of banks other than PKO BP have begun to offer mortgage finance, and still others have stated their interest in mortgage lending.
- While PKO's share of the outstanding balance is still dominant, its share of new loans in is falling. Estimates through November 1996 indicate that perhaps as much as 40% of new lending originated outside PKO BP.
- Technical assistance associated with the Mortgage Fund -- the work of the Housing Finance Project Office (HFPO) and demonstration effect of the DIM, for example -- have helped the sector move toward market-oriented strategies.
- Poland's substantial efforts in banking reform, which focus on strengthening banking institutions, will help support the development of the housing finance sector.

At present, there are important signs of change in housing finance. These are summarized in Box 3.2. As the sector evolves, a number of important structural changes should ensue: not only will the level of residential investment as a percentage of GDP increase, but the share of credit extended by housing finance institutions, especially relative to government support, will increase. Wholesale funds will be obtained from the capital market through a mortgage banking structure. The Mortgage Fund may continue to provide refinancing to a number of participating banks, and, as discussed in Section 3.3, could eventually be privatized. Equity provided by households will increase as housing activity increases, but will decrease as a proportion of the amount needed to finance a given dwelling. Thus, more households should be able to afford larger housing loans. In response to these important developments, the Polish Banks Association has formed a Mortgage Lending Committee within the Association. As will be discussed, there are numerous sectoral development issues which can benefit from the Committee's deliberations and assistance.

3.2 Activities and Actors in Private Housing Finance

The Commercial Banking Sector. The structure and condition of the banking sector in Poland has substantially improved since the beginning of the reform process in 1993, with the Enterprise and Bank Restructuring Program (EBRP). The reform of the banking system under EBRP has been considered a model of commercial banking reform for transition countries. Although the results are felt to be mixed, the EBRP did force banks to confront their debt problems and improve institutional capacity in their workout units.[24] Most banks are now cleared of at least some past bad debts (PLN 4 billion of State Bonds were capitalized as of March 1996). Four private financial institutions have been established[25] and National Bank of Poland (NBP) and the Ministry of Finance have issued licenses to 14 foreign commercial banks or joint ventures (joint ventures have some amount of foreign capital).[26] The market has also seen the creation of small private Polish banks.

However, there is also a great deal that remains to be accomplished. Future bank growth could be weakened by numerous factors. Clearly, the process of consolidation and privatization is complex and still ongoing. Factors internal to the structure and operation of the banks include undercapitalization, low credit/asset ratio (35 percent), inadequate support systems (so-called back-office technology), lack of trained managers, and high operational costs. Externally, the nascent state of the long-term capital market and lack of a variety of investment products has led to dependency on state securities as the banks' main investment asset. Also, as NBP strives to place an appropriate regulatory framework in place, banks have had to adjust to a variety of changes. Finally, with regard to issues specific to housing finance, uncertainties regarding collateral, discussed at length in Chapter 4.0, and lack of a regulatory environment directed at long-term mortgage lending will require further adjustments.

During 1996, Polish banks displayed a strong interest in retail activities. During the first nine months, the total volume of households' deposits rose by 31 percent and the stock of retail credits by 51 percent. (However, retail credits still constitute only 12 percent of total credits.) Banks consider the retail market as being promising and profitable; although about 70 percent of the population does not yet hold retail credit, household incomes are rising and the need for financial services is expected to follow. Banks enter the retail market through special products (credit cards, credits for car purchase). Some now rely on a growing demand for mortgage loans to cross-sell other retail products.

Mortgage loans. The National Bank of Poland provides data on the balances of mortgage loans recorded by all banks. The data show the outstanding balance of housing loans at the end of August 1996 to be PLN 6.174 billion. A large part of the aggregate balance, however, corresponds to the old portfolio of PKO BP, which includes different types of loans that have been subject to various changes (capitalization and repurchase of interest, transfer off balance-sheet, etc.). Although the data show an increase of PLN 596 million during the first 8 months of 1996, ***this figure includes the negative amortization of the old portfolio and thus significantly overstates the volume of new lending.***

[24] See Gray and Holle, "Bank-Led Restructuring in Poland: Bankruptcy and its Alternatives."

[25] Wielkopolski Bank Kredytowy, SA; Bank Śląski, SA; Bank Przemysłowo-Handlowy, SA; and Bank Gdański, SA.

[26] Refer to Financial Services, Ltd., *Review of the Status of Polish Capital Markets* for more information on the banking sector.

Based on an examination of bank records, we estimate that during the first semester of 1996, the total production of new credits was about PLN 210 million. During the same period of time, fewer new housing units were completed (21,500 units, with an average area of 96 m^2 versus 26,500 units with an average area of 89 m^2 during the first semester of 1995). The total declared number of single-family homes under construction in 1996 was larger, however. Thus, although the use of the bank financing of housing is still quite limited, the sector seems poised to offer a very new profile, as summarized in Box 3.3.[27, 28]

Box 3.3
Market-Based Housing Finance Today:
The Sector is Evolving Rapidly

- Competition among banks is increasing:
  PKO BP originated only 60 percent of new lending during 1996.
  Other banks originated 40 percent during 1996. Eighteen banks are now active in housing finance.

- Mortgage products are increasingly varied, and include:
  DIMs eligible for the mortgage fund;
  Traditional/commercial credits;
  Foreign currency denominated loans; and
  PKO BP's new DIM loans.

- Mortgage lending terms vary widely:
  Loan/value ratios range from 25 percent to 75 percent.
  Effort ratios (payment/income ratio) range from 17 percent to 33 percent.
  Average loan amounts for different banks range from PLN 21,000 to PLN 70,000.
  Maturities range from 7 years to 20+ years.

PKO BP. Housing finance is still dominated by PKO BP. PKO BP's total housing portfolio is approximately PLN 6.098 billion (as of September 30, 1996) divided as follows:

- PLN 5.77 billion (90 percent) represents the "old" portfolio, credits delivered until March 1995, mostly to or through housing cooperatives. This portfolio is tied to large and unpredictable balances and cash flow depending on inflation, state subsidies involving repurchase of interest, and low fixed interest rates for credits issued before 1992. The portfolio balance is declining but will receive significant subsidies for about 7 more years.

- PLN 328 million for the "new" housing portfolio (credits originated since August 1995):
  — PLN 11 million to housing cooperatives;
  — PLN 317 million to households (including PLN 286 million of deferred-payment loans).[29]

PKO BP's portfolio of new mortgage loans represents more than 15,500 borrowers, including 11,277 from January through September of 1996.[30] **The number of credits** is not substantially different from prior years; **however, the new loans are unsubsidized, in stark contrast to the old portfolio.** The average individual loan has been quite small, about PLN 21,000 since August 1995 and about PLN 25,000 on average during 1996 (January through September).

[27] Anecdotal evidence suggests that the vast majority of new loans are for new construction. We found no reliable or complete data on the breakdown of housing investments by type (new housing, existing housing, rehabilitation, etc.).

[28] Data are available for the first 11 months of 1996.

[29] There are also PLN 308 million of other loans which are probably not housing loans.

[30] The loans are mostly variants of Dual Index Mortgages.

The production of these credits represented about PLN 280 million during the first eleven months of 1996. This represents about 60 percent of the total volume of new banking credits for housing; in terms of numbers of credits outstanding, it represents over 80 percent of the market. However, PKO BP's market shares are steadily declining; only two years ago, PKO BP had a monopolistic position with a market share well above 90 percent. This evolution is positive for the housing finance sector. While the growth of PKO BP's portfolio was strong during the third quarter of 1996 (up 51 percent), it was in line with that of other banks active in mortgage and construction lending.

PKO BP now has far more deposits than credits. The deposits are relatively cheap funds from sight deposits (these deposits are insured by the State for up to PLN 32,000 per depositor). The funds are invested primarily in State securities. Thus, given its liquidity position, it is likely that PKO BP will continue to be an aggressive lender, although its activities could be constrained by the need to be modernized and diversified.

Despite its new initiatives and continued majority market share, PKO BP does face certain structural and administrative problems and the problematic potential of its old portfolio. Its overall portfolio is clearly not diversified, as those of the competing banks are. Its operational costs may reflect an overstretched network and lack of modernized procedures. Given the nature of its portfolio, PKO PB could actually face losses if inflation falls; thus, more work could be done to encourage prepayments.

Other Commercial Banks in Housing Lending. From January through November 1996, other banks originated approximately PLN 180 million of mortgages -- 40 percent of the market in new lending during the first 11 months of 1996 as measured in zlotys.[31] In addition, 18 banks are now active in housing finance in Poland (about 30 percent of all banks, excluding local cooperative ones). **This is a major change from 1995 when only 3 banks** other than PKO BP were active (PAMBank, PBG, and BISE). **These events mark a recent and very important development in terms of introducing competition and multiple lenders into this new, but potentially large, market.** This total is spread among the 18 banks which now issue mortgages; the average size is estimated to be PLN 60,000, which is several multiples of the average PKO BP loan.

The second largest housing lender is **PAMBank,** the Polish American Mortgage Bank, which reached a housing portfolio of PLN 57 million as of September 30, 1996. This represents 17 percent of PKO BP's total new portfolio, and probably about 10 percent of the total current banking production of mortgage loans. PAMBank issues loans through two offices, in Warsaw and Gdansk (in contrast, PKO BP has 374 outlets). PAMBank has efficiently organized its activities; its portfolio performance is positive: there have been no defaults, the portfolio has grown significantly, and the margin is relatively large.

PAMBank's next challenge is enlarging its portfolio in order to reach a more sustainable level of profitability. This may require a larger network, larger servicing capacities, a larger range of more affordable mortgage products, and more diversified refinancing lines. Its development should then gradually include more zloty credits with deferred interest.

The Mortgage Fund now finances four banks with the prospect of adding several more in 1997. The Fund's portfolio, as of October 1996, was PLN 11.7 million. PLN 15.7 million is disbursed and 25.5 million committed (the difference represents the growth in mortgage credits and also the delays for the Fund's refinancing lines). The Mortgage Fund portfolio -- PLN 11.7 million -- represents approximately 21 percent of PAMBank's portfolio and 4 percent of PKO BP's new portfolio. The Fund's portfolio should reach about PLN 17 million at the end of 1996 ($U.S. 6.2 million, with larger figures for disbursed and committed

[31] Other banks initiated 40 percent of new lending as measured in zlotys and about 20 percent as measured by the number of loans.

credits). More detailed data on the situation and the perspectives of the Mortgage Fund are provided in Section 3.3.

Commercial/Conventional Housing Loans. Many Polish banks have been delivering "traditional" mortgage loans in zlotys (no deferred interest, short-to-medium maturity).[32] There are no current aggregate figures about the volume or their respective shares. The volume of commercial mortgage loans is estimated to be about 30 percent of the total 1996 housing loan production.[33] This trend is promising, as the aggregate commercial bank network covers a large part of the potential national demand, and can potentially compete with PKO BP. However, only a limited percentage of bank networks are actually currently prepared to deliver mortgage loans. The relative success of commercial bank "traditional" mortgage lending, despite theoretically lower affordability (that is, lower than the Mortgage Fund's DIMs, or U.S.$-denominated credits, or PKO BP's new products), reflects their simpler originating and servicing procedures, and a **targeting of product offerings at high income households**.

3.2.1 Mortgage Products and Affordability

There are four major groups of mortgage products originated by the banks in Poland: DIMs eligible for Mortgage Fund, traditional credits, foreign currency loans, and PKO BP's new DIMs. Their characteristics are summarized in Table 3.1. Some banks deliver a number of different products to meet the needs of various groups of borrowers. Some banks participating in the Mortgage Fund sell other traditional or hard-currency denominated credits whereas others extend dual index mortgage PLN credits, to absorb a growing demand from middle-income households. The Mortgage Fund is also introducing, as eligible for refinancing, other affordable products (e.g., Deferred Payment Mortgages, with simpler commercialization than DIMs).

No type of mortgage credit (the Mortgage Fund's or any others) yet finances "high" loan-to-value ratios. Commercial banks with classical credits have generally financed a higher income group of borrowers than other lenders; nevertheless, mortgage lenders seldom provide high loan-to-value ratio loans. PAMBank provides the largest average loans (PLN 75,000). The largest loans for banks participating in the Mortgage Fund were delivered by BISE (from the Fund: average PLN 66,000 for 118 m^2; PLN 70,000 average in total), which mostly operates in Warsaw. The average surface area of eligible units may be compared with other new construction: in 1995, 40 percent of new units were built by cooperatives with an average size of 61 m^2 and 47 percent by individuals with homes of an average size of 122 m.^{2} The Fund has mostly financed moderate to higher income clients; however, 20 percent of its borrowers have incomes below the national average.

[32] The term "traditional" refers to self-amortizing, level payment loans (either fixed or variable rates). Delivering banks: PKO SA, BGŻ, PAMBank, PBG, PBK, BPH, Bank Śląski, Bank Zachodni, BDK, GBW, Cukrobank, PBI, Bank Podlaski, Petrobank, PKO BP, Investbank, GBG, and BISE.

[33] The percentage share of the total is likely higher than 30% for short-term multifamily construction loans to developers and cooperatives, and likely lower than 30% on long-term mortgage credits (often still experimental for many banks).

Table 3.1
Mortgage Products in the Polish Market

	DIMS Eligible for the Mortgage Fund		Traditional / Commercial Mortgage Loans		Foreign Currency Denominated Loans		PKO BP's DIM Loans (new loans since 9/95)	
	M	A	M	A	M	A	M	A
Loan / Value Ratio	70-75%	46.5%	60-75%	40-50%	70%	50%	70%	25-30%
Effort Ratio (payment/income)	25%	17%	33%	NA	33%	NA	NA	20%
Loan / Income Ratio	27	15	NA	NA	NA	NA	NA	NA
Maturity	15-18 years	7 years	15 years	10 years	15 years	10 years	20-40 years	10 years[4]
Average Loan Amount	60,000 PLN		40,000 PLN		70,000 PLN		21,000 PLN	
Average Monthly Gross Income[1]	(3,572 PLN)		NA		NA		NA	
Interest Rate	21.5-23.5%[2]		24-25%[3]		12-13% ($US)		23.5-25.5%	

M = Maximum
A = Average

1 This figure is a crude estimate of household income for a 2-worker family, each worker with average income of 1,786 PLN per month.
2 Rate = 13 week Treasury Bill + Bud-Bank margin + Participating Bank margin
3 Rate = WIBOR + margin
4 The duration is not fixed. In practice, duration may be less than 10 years.

Commercial banks with traditional credits have financed a somewhat higher income group. Commercial bank mortgage loans may be offered by accepting a higher initial effort level (payment-to-income ratio); the effort ratio may decline later, which may require a longer maturity and higher interest rates. The potential "tilt" effect (the difference in payment-to-loan amount between a DIM and traditional credit) is still higher than 50 percent. However, the Fund has not exploited its full potential: maturities are short and more interest could be capitalized. (This is not the case with commercial credits, which may have reached their limit even with high income clients and longer maturities.) In order to improve its competitiveness, the Fund should promote its currently lower interest rate and higher loan-to-value ratio.

Average monthly family income figures have been very roughly estimated for recipients of DIMs eligible for the Mortgage Fund at PLN 3,572 monthly. (See Table 3.1 -- this figure assumes a two-worker family, each worker earning PLN 1,786 per month.) This monthly income (which translates into an approximate annual income of PLN 42,000) represents a loan/income ratio of 18.5 for a "typical" PLN 66,000 loan from BISE. Note that Table 3.1 estimates that the maximum loan/income ratio for DIMs eligible from the Fund is 27 and the average may be around 15. (Comparable income estimates are not available for the other lenders.)

The incomes of PKO BP's clients appear to be somewhat lower than those obtaining loans from other banks. PKO BP also sells DIM variants, but the average mortgage amounts appear to be substantially lower (one-half to one-third as much) than other banks' mortgage loans, with very small loan-to-value ratios. The design of PKO BP's products may partially explain this phenomenon; the issue is complex, however, and may also involve an unpredictable and/or volatile evolution of repayments. Nevertheless, PKO BP's large network and its image as a housing bank remain considerable assets.

The hard-currency denominated credits are quite costly, particularly for those households earning no substantial hard currency income, and are thus exposed to long-term foreign exchange risk. These loans actually capitalize interest in Zloty equivalents.[34] PAMBank's products became quite expensive in 1996 for Polish households, because of the real appreciation of the Zloty. For example, a Mortgage Fund long-term DIM valued in $U.S. equivalent would generate a floating $U.S. interest rate of about 7 percent to 8 percent, versus PAMBank's 12 percent to 14 percent rates.

Finally, many transactions (even for new housing) were financed in 1995 by cash or very small consumer-type credits. Importantly, however, most of the entrant banks started to deliver standard commercial credits; these are easier for them and for clients, and are viewed internally as equivalent to car credits. The most advanced banks are planning the introduction of deferred interest loans in Zlotys to complement their current product lines. This is a strategic necessity because the first wave of higher income clients may soon decline.[35]

In conclusion, although affordability problems stem from several sources, the high cost of credit is probably one of the foremost issues. Compounding this is the conservative nature of both borrowers and lenders, reflected in the short terms, and payment of interest that could be deferred. For example, to again use figures available for DIMs eligible for the Mortgage Fund, at an assumed cost per m^2 of PLN 960 (this has been the nominal average since 1994), a unit with 150 m^2 would cost approximately PLN 144,000; this represents a loan/value ratio of about 42 percent for an "average" PLN 60,000 loan. This conservative approach stems at least in part from long-term uncertainty about income and employment (so-called permanent income). In any event, **more could be done to commercialize the DIM, which is growing in acceptance and offers a relatively affordable product.**

3.2.2 Sector Growth Issues

Demand for Mortgage Credit. There is a wide variation in estimates of demand for housing finance for the next few years. Despite a reduction in tax deductions for new housing in 1997, most of the banks still forecast a positive growth in demand, or at least think that their targeted objectives can be met. If there is a limiting factor, it may come from their own capacities to originate, sell, service, and refinance mortgage loans and from the lack of centralized and reliable data on household income and debt.

Major reasons for the relatively slow growth in mortgage demand include the lack of certainty regarding income in the long run (permanent income as noted above), relatively high tax liabilities, the **low relative price of existing rental housing** units (generating less demand for new housing), and the competition of consumer credits. Incomes should continue to improve as the economy stabilizes; revisions to rent policy in communal housing will require a continuing series of reforms, as discussed in Chapter 5.0. The relative cost of mortgage credit is certainly an issue, but not the only one cited as a major deterrent in the sector. Many households that potentially could take on credit or assume a larger credit (particularly with a DIM) choose not to for the reasons noted above.

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[34] Re-appreciation of the outstanding balance results from the change in foreign exchange rate.

[35] PBG represents an interesting example, a large bank active in housing, which originates both DIMs and traditional credits. PBG's latest estimates for 1997 show equal projected volumes (PLN 8 million for both DIMs and "traditional" credits), although DIMs are sold in fewer offices than are traditional credits. One third of PBK's initial demand is focused on DIMs. PKO SA originates traditional credits (it expects 2000 credits in 1997 from the higher-income group of its 1.5 million clients), but a DIM-variant is being actively prepared as well.

Credit Risk of Mortgage Lending. All banks have mentioned the legal uncertainties pending on mortgage collateral (statutory tax lien, ranking on Mortgage Register, Court delays of registration, high eviction costs and delays) as a major deterrent to expanded lending. Despite these concerns, many banks are beginning to enter the market, driven by competition for clients. The banks identified legal issues as one of most important candidates for foreign technical assistance (for example, modernizing and computerizing the land registry). These issues are addressed in more detail in Chapter 4.0 of the report.

Internal Organization of Lenders. Banks face many internal organizational issues. Mortgage servicing is nearly always quoted as a barrier to larger-scale production. In response, some banks have started to restructure their support and processing systems. Most mortgage servicing is done by stand-alone PC-based systems and not integrated into the overall (mainframe) systems of the bank. There are no standards for system design within Poland. Various technical issues have been mentioned as desirable areas for technical assistance. Short-term strategic advice is also expressed as a need.

Real Estate Development Finance Issues. Most of the banks active in mortgage finance have developed commercial policies for new mortgage loans in cooperation with developers and cooperatives. In fact, competition in "cooperation" has started. Despite this progress, the banks note the following problems:

- the lack of equity from developers and the risky policy of using the advances from clients;
- the lack of professionalism of developers, particularly in the control of construction risks and costs; and
- higher risk of lending to cooperatives (uncertain final price, no owner equity, specific legal cooperative issues).

On the other hand, banks are often reproached for a number of shortcomings, including:

- a lack of trained underwriting teams;
- excessive delays and requirements for large projects;
- the lack of financing for land and infrastructure (seen as a quite risky business by banks);
- the lack of bridge financing for households; and
- lack of financing for existing housing (due to delays, the small amounts of the loans, and lack of cooperation with realtors).

Construction loans are available for both individuals and developers. The maximum term is 24 months and the contractor must invest 20 to 40 percent of its own funds. These funds are generally obtained from clients, which forces the developer or construction company into the situation of managing money for clients. The dependence on client funds also leads to delays and uncertainties for developers. There is only one equity investor in real estate in Poland (HDC). It provides funds in return for a share of the project and works in conjunction with the bank's construction loan finance team.

3.3 Future of the Mortgage Fund

3.3.1 Review of Performance

The Mortgage Fund was created in 1993 to catalyze the development of market-oriented housing finance. It offers attractive long-term lines in Zlotys to primary banks for construction and long-term mortgage credits. As of October 31, 1996, the Mortgage Fund's portfolio was PLN 11.7 million (15.7 disbursed, 25.5 million committed). This portfolio should reach PLN 17 million at the end of 1996 ($U.S. 6.2 million). The Government budgeted PLN 50 million for the fund in 1996. However, the Fund's resources have already been reduced twice, from $U.S. 400 million to $U.S. 50 million. The World Bank's credit line has fallen by a factor of 10 (from $U.S. 200 million to $U.S. 20 million). EBRD's credit line for construction credits has recently been canceled.[36] Less than one third of USAID's Housing Guarantee loan has been disbursed to participating banks; nevertheless, as discussed below, we feel that the Mortgage Fund can contribute to the development of the market-based system of housing finance in Poland and thus could benefit from continued utilization of Housing Guarantee funds.

The Mortgage Fund was intended to be a major factor in the development of a market-based housing finance sector in Poland. Its role includes facilitating investments identified as having a very high rate of economic return, catalyzing other resources, introducing affordable and innovative mortgage products to jump start affordable lending in an inflationary environment, and enabling retreat of the public sector from housing finance. The Mortgage Fund was to have had two lines of credit: one for mortgages for households (27,000 loans) and one for construction lending (for 15,000 units).

Clearly, the Mortgage Fund has not disbursed as expected. Some possible reasons for that are noted below, since an understanding of the Fund in the present environment is a key input to possible recommendations for the future. **However, the Fund has provided important inputs to housing finance policy in Poland.** The implementation and support unit, the Housing Finance Project Office (HFPO), has assisted lenders and developers and has focused attention on development of market-based policy initiatives and mortgage products. The most innovative reform was likely the DIM, which attempted to achieve full cost recovery in a difficult environment of high and volatile inflation and uncertain movements in real wages. The DIM approach is now utilized independently of the Fund by a number of banks in Poland.

The Fund is "hosted" by the Bud-Bank SA, which was expected to transform itself into a refinancing agency and close its commercial activities by 1995 (a deadline since extended twice, until December 1997). This expected transformation was based on the projected scale of the Mortgage Fund in 1993 and the conflicts of interest inherent in retail lending and apex refinancing.

The Government of Poland's involvement has been the following:

- capitalization of Bud-Bank in 1993;
- guarantee of the World Bank's line, and commitment fees to international donors;
- coverage of foreign exchange risk on the World Bank's line;
- co-financing of 50 percent of the Fund as equity, to **capitalize** the Fund (no repayments due);

[36] The original financing was a $U.S. 25 million Housing Guarantee Loan, a $U.S. 200 million World Bank loan, a $U.S. 67 million European Bank for Reconstruction and Development (EBRD) loan, and $U.S. 133 million to be contributed by the Government of Poland. In addition, USAID and the World Bank have provided extensive technical assistance in such areas as development of the DIM, operational procedures, and assistance to HFPO. As noted, the Government budgeted PLN 50 million for the Fund in 1996.

- $U.S. 7 million advance to be used until the portfolio is larger and more profitable; and

- allowance for participating banks to treat their capitalized interest from mortgage credits as financial income, while paying income taxes only on paid interest.

A variety of critiques of the Mortgage Fund have already been conducted. Some of the issues raised address the Fund's implementation. Some initial administrative and refinancing conditions were felt to be very cumbersome. The Fund's refinancing procedures are seen as complex for multifamily credits. The refinanced affordable products were not well promoted (notably the deferred interest). The confusing roles and images of Bud-Bank and Participating Banks also hindered the Fund. Also, the economic context impacting demand for Mortgage Fund loans has not been favorable. Many banks were, or still are, liquid; the banks have had sufficient short-term funds of their own and the demand for mortgage loans has been depressed. As discussed below, however, this situation has begun to change. Procedures are now more efficient, as many reforms have been introduced. Many administrative constraints have been reformed. Refinancing relationships could still be improved, however, with more modernized and computerized procedures, and staff better oriented toward the technicalities of mortgage banking.

The major issue that must be addressed, however, is the apex structure for the Mortgage Fund. Bud-Bank was apparently not fully prepared and/or desirous of playing a difficult (and self-limiting) apex banking role. The lack of the Fund's success quickly worsened chances for Bud-Bank's support of the original plan involving its transformation into a refinancing bank. This objective now looks impossible, given the current small portfolio and the drastic fall in the Fund's resources. Bud-Bank's strategy is thus blocked: neither financial growth from the Fund nor development of its own retail activities are feasible. At this point**,** Bud-Bank's ambitions are to be a **direct mortgage lender,** like participating banks, and **perhaps an apex as well.** This right was denied by the World Bank's contract, because of the resulting conflicts of interests with participating banks. However, Bud-Bank's desire to become a retail lender has worsened the Fund's credibility in the eyes of participating banks, as the Fund has little operational independence from Bud-Bank (only separate accounting is required).

3.3.2 Current Situation

Four banks now cooperate actively with the Fund: PBG, BISE, GBW, and GBG. The scope of their future investment in housing depends on the existence of the Fund's long-term Zloty lines. At least two other major banks declared an intention to use the Fund's resources in 1997: PAMBank and PBK. The situation of the actively participating banks is the following:

- **PBG** is the major client of the Fund, but the three other banks also show an increasing participation. PBG sells about the same number of DIMs as its own commercial credits (15 years, Wibor + margin), although far fewer of PBG's branches are trained and equipped to sell DIMs. This is significant for at least two reasons: (1) DIM loans are now increasingly and actively being requested by the bank's customers in their 39 branches and (2) the loan volume continued to rise in January 1997, even after the tax concessions for new construction were withdrawn at the end of December 1996. PBG has always declared their leadership ambitions in mortgage finance and has invested significantly toward this end.

- **BISE's** small operation in Warsaw expects more than 200 mortgage credits to be delivered at the end of 1996; most of these credits are subject to the Fund's refinancing. As its lack of network limits its development, BISE intends to open one or two branches outside Warsaw in 1997, and also sell mortgage credits through the network of at least two regional banks.

- **GBG** is a relatively new arrival in the mortgage business, but a dynamic one. Its network of eight branches covers southern Polish cities (from Bielsko-Biała to Krakow). **GBW** is reported to have made about 80 new mortgage credits in 1996.

A number of **important technical improvements** have been implemented or recently approved for the Mortgage Fund:

- mortgage credits are more affordable and more appealing (larger eligible surface areas, no maximum effort ratios, more attractive products);

- cheaper refinancing lines of pooled credits, broader and simpler eligibility rules including existing housing;

- Bud-Bank no longer requires additional mortgage registration and has introduced more user-friendly software; and

- multifamily construction credits are now more easily eligible for refinancing.

3.3.3 Future Demand

In addition to the banks currently participating, other banks have approached the Fund. Some were qualified and trained as participating banks, but have either not become mortgage lenders or Fund borrowers at present. These banks include PBI, Petrobank, BWR, PBK, PKO SA, Glob-bank, and PAMBank. An important issue for the future is correctly forecasting the interest of such banks.

Given the adequacy of their own liquidity position, few large public banks currently have any financial incentive to use Fund's lines. **Because of their large deposit bases, the two largest retail banks -- PKO SA and PKO BP -- are not likely to use Fund's lines in the near future (there were prior unsuccessful negotiations with the PKO BP). PKO SA has just started a small production of commercial mortgage credits and is preparing a DIM product for 1997.**

In assessing the level of interest in Fund participation in the future, one factor may be bank size. For example, larger banks can use their own funds, as long as their mortgage portfolio is not too large. In contrast, a small bank with a limited deposit base may have fewer choices and would welcome this source of liquidity. There is general awareness of the transformation risks (as noted by BPH and PBG). **Importantly, the cost of funds does not appear to be a major issue.** Once all reserves and costs are considered, the actual cost of own funds is quoted to be at least comparable to costs for the Fund for other banks (including PBG or PBK). Preliminary estimates of demand for Fund credits for 1997 and 1998 is placed at $U.S. 31 million. These estimates include potential demand from PAMBank and PBK.[37] Already, $U.S. 10 million are committed. A possible participation of PAMBank would support the view that the Fund should remain at least at its current size of $U.S. 50 million.

Financial Structure

Selected financial data (in PLN millions) on Bud-Bank and the Mortgage Fund, subject to auditor's certification for 1996[38] are presented in Table 3.2.

Despite a very small portfolio, the Fund has contributed to Bud-Bank's profits. Its income comes from:

- the budgetary advance (equity equivalent to $U.S. 5 million), which generates stable income;[39]
- the Apex's spread on the disbursed portfolio (initially 2.1 percent, now between 0.5 percent and 2.1 percent: 1.1 percent on average);[40] and
- the budgetary co-financing for which there are no interest payments (i.e., equity).

[37] PAMBank has also applied for the Fund's $ U.S. refinancing ($U.S. 7 million accepted by Bud-Bank for possible funding from the World Bank line, but the final decision has not been made by the Ministry of Finance).

[38] U.S.$ = 2.8 PLN at the time this report was written. In 1996, U.S.$1 = 2.6 PLN in average. In 1995, U.S.$1 = 2.42 PLN in average.

[39] This advance is gradually disbursed (pro-rata to World Bank's Special Account's withdrawals); only one half of World Bank's loan has been withdrawn.

[40] Plus an additional "hidden" spread (0.2%-0.3%) which results from the fact that balances due by participating banks are accrued on a monthly basis, whereas balances due to the Budget are accrued quarterly.

Table 3.2
Financial Structure of the Bud-Bank Mortgage Fund
(PLN millions)

	Through October 31, 1996			Full Year 1995		
	Consolidated Bud-Bank	Mortgage Fund	% Share of Fund	Consolidated Bud-Bank	Mortgage Fund	% Share of Fund
Assets	157	30.8	20%	126.1	23.1	18%
Equity	62.5	19.9	32%	58.4	17.8	30%
Including Budget Equity		16.9			14.7	
Balance portfolio	70.2	11.7	17%	50.7	6.6	13%
Financial Securities	49.4	18.2	37%	49.9		
Gross Result	7.8	1.1	14%	6.8	1.4	20%
Net Result	5.5	0.7	13%	5.1	0.6	12%
After Income-Tax Reserves	5.3	0.7		2.5	0.1	
Total Expenditures	18	3.4	19%			
Wages + Charges	5	1.1	22%	5.1	1.2	23%
Other Operational Costs	4.7	1.2	25%	4.6	??	
Financial Costs		1.1			0.7	
Total Income	25.8	4.5	17%			
Interest Income	9.4	2.8	30%	12.4	3.5	28%
Other Income	10.6	1.6	15%	10.4	0.9	8%
Return on Assets				1.98%		
Return on Equity				4.28%		

However, the profitability of the Fund for the Bud-Bank is clearly declining. In 1997, losses could occur if the budgetary advance is to be repaid. The operational costs of the Fund look somewhat high: 22 percent or 23 percent of the total for Bud-Bank as compared to about 18 percent to 20 percent of assets (in 1995 and the first 10 months of 1996). These costs are about three times more than the actual costs of the Mortgage Fund's staff (other Bud-Bank departments work for the Fund and charge their corresponding expenditures to the Fund). The total costs could probably be reduced through some modernization of procedures, better management, and/or the use of external subcontractors.

3.3.4 Options for the Future

The future of the Mortgage Fund is clearly in question. Policymakers have been disappointed in its results and question the need to continue both the World Bank credit line (with commitment fees) and the GOP's budgetary commitment. Bud-Bank is in a difficult strategic situation. Some of the major issues are the following:

- Bud-Bank may be over-capitalized; it possesses a small network (3 branches), limited portfolio, and few profitable activities.

- Bud-Bank is forbidden to deliver construction and mortgage credits on projects eligible for the Fund.

- A feeling of uncertainty affects both its banking clients and its own staff. Several Fund staff recently left and some of Bud-Bank's remaining staff are said to feel frustrated by their inability to act as a direct lender.

- The Fund is the object of regular criticism from the GOP (an audit was recently done for the Prime Minister), and rumors of its termination or reduction are regularly spread.

Given this uncertainty, one approach would be for Bud-Bank management to seek release from the constraints on direct lending. **It is also appropriate for the GOP to ask whether the Mortgage Fund continues to serve an important role in the development of the housing finance system and whether its remaining budgetary commitments should be reserved for the Fund.**

In any event, there are three choices for the Mortgage Fund which need to be considered:

- continuation with Bud-Bank as host, perhaps with some marginal relaxation of retail constraints;

- termination of the Fund; or

- continuation of Fund operations with another host.

3.3.4.1 Short-Term Role of the Mortgage Fund

It is our opinion that the Mortgage Fund should be maintained, in part because its funds are likely to be consumed during the next two years. In addition, in support of the goals for private sector housing finance set forth in Chapter 1.0, **in the long-term the Mortgage Fund could continue as a private or (public/private) refinancing facility.** At least four banks, now active in the Fund, have determined their strategy under the premise of continued participation in the Fund. Since more banks are now becoming active in housing finance, they may join the Fund's program. They may **increase** their demand for the Fund products (cheaper rates, more affordable loans) as they diversify their lending to more average income targets. Discussions with some large non-participating banks indicate that they expect to use the Fund. Some non-participating banks that do not currently use the Fund treat its presence as a ***stabilizing factor,*** should their portfolios grow. The Fund's liquidation could thus diminish banking involvement in housing finance.

Also, at this stage of the development of the housing finance system in Poland, it is important to develop ***competition*** among lenders. The Fund facilitates this objective by allowing new entrants in the business to tap long-term funds. Without the Fund there is a danger that the mortgage market could be dominated by a few large, state-owned banks such as PKO BP, PKO SA, and Bud-Bank (if freed from its direct lending restrictions). **The Fund is clearly more valuable to smaller banks both as a source of funds and as a way to manage transformation risk. Such banks can be a source of both increased competition and product innovation.**

Another rationale for continuing the Fund is that it serves a valuable function in reducing the ***systemic risk*** of maturity transformation in the Polish banking system. Although many banks (particularly the large banks) are currently quite liquid and thus not interested in the Fund's products, the system is still fragile. A large banking failure could significantly reduce bank liquidity; this would be quite restrictive toward housing lending, because such lending is long-term in nature. The Fund also allows smaller banks that are less liquid to reduce their risk of housing lending.

As discussed above, the Fund also continues to play a very important role in ***product innovation and standardization***. The acceptance of the DIM is growing, and the Fund is launching a new product, the Deferred Payment Mortgage. Fund products are transparent, which cannot be said for all mortgage products on the market. (In particular, some lenders use their internal cost of funds rather than external indices to revise customer mortgage rates.) In this context, the Fund could play a significant role to accelerate the development of mortgage banks in Poland and/or be maintained as a regulatory body for the mortgage industry.

The costs and equity needs of the Mortgage Fund are very small for the Government of Poland, particularly when compared to other major uses of funds (plans for the National Housing Fund, PKO's old portfolio, tax exemptions for new housing construction and potentially for the Contract Savings System). ***The costs of maintaining the World Bank loan to the budget could be defrayed through commitment fees charged to participating banks.*** The banks could extend a commitment for their required funds until 1998 and pay a symbolic commitment fee (for example, the 0.2 percent of the World Bank's fee applied on half of the funds).

3.3.4.2 Need to Separate from Bud-Bank

The original concept of Bud-Bank's gradual transformation into a refinancing bank should be abandoned. Because of current and potential low Fund size and spread, Bud-Bank's future as an apex lender is quite uncertain. It is our understanding that Bud-Bank would prefer to become a mortgage bank, directly originating mortgage credits, and openly competing with other direct lenders. A suggested compromise -- to let Bud-Bank finance any real estate project ineligible to the Fund -- cannot sustain its banking growth; construction and mortgage credits represent the pillars of housing finance, around which other activities can be developed. Finally, for mortgage credits, Bud-Bank also needs the Fund's refinancing conditions (reflecting its own high cost of funds).

The two functions, refinancing apex and direct lender, are not compatible. It is a clear conflict of interest for Bud-Bank to be both a competitor with and lender to other banks. This conflict of interest is particularly evident for large multi-family construction credits. A forced co-habitation would generate the possible withdrawal of participating banks. These latter have mentioned the problem that Bud-Bank has obtained considerable information from them about their lending portfolios.

The best solution would be **the separation of the Mortgage Fund from Bud-Bank as soon as possible.** This strategy would achieve two goals: (1) allow Bud-Bank to pursue a retail lending strategy (and become a mortgage bank if such legislation is passed), and (2) provide for a more stable operating environment for the Mortgage Fund. This change will require that the Fund be given a new hosting structure. The logical host for the Fund is the National Bank of Poland (NBP), which is a shareholder of Bud-Bank for the Fund.[41] It is responsible for supervisory functions for banks as well as the future supervision of mortgage banks. For the time being the Fund would not have to be given a pseudo-bank status, but just act on the behalf of NBP. As discussed below, this move could be a transition to privatization through sale to participating banks.

A quick decision should then be announced to alleviate two current problems:

- a speedy transition for participating banks, to allow uninterrupted Fund activity and allay concerns over Bud-Bank activities; and

- the adverse selection process of departures of experienced Fund staff from Bud-Bank.

3.3.4.3 Transition Issues

The Mortgage Fund must maintain a sound financial structure. This means that it should keep the current budgetary advance (about $U.S. 6 million) as equity at least through 1997. If growth in the Fund is weak, the equity contribution could be allowed to gradually decline thereafter. At current and projected volumes of lending, there would be no need for additional equity from the GOP. The current level of equity of the Fund will support a loan volume of $U.S. 50 million at current NBP capital requirements. This would allow the **transformation of further budgetary co-financing from equity to debt** (subject to a modified subsidiary agreement).

If the Fund does not grow appreciably during the next two years, the equity contribution can be returned to the Budget over time as the portfolio liquidates. **If the portfolio grows significantly in size, then many options are opened, including more international credit lines with budget co-financing, privatization as a refinancing mortgage bank, or creation of a public refinancing bank.** Private or public equity may then be needed, but there is little justification for providing it through the Budget now.

It is important to maintain the scheduled budgetary contribution ($U.S. 20 million) so as to offer a credit line of credible size for participating banks. Should the GOP accept the Fund's refinancing of PAMBank's $U.S.-denominated credits, a compromise solution would consist of diminishing pro-rata the Budget's co-financing obligation (as there is no reason to use budgetary funds for $U.S. refinancing). The Budget's line would then represent $U.S. 13 million (equivalent).

It will be important for the Fund to continue to operate in a financially responsible manner. This means keeping the current lower level of spreads (average 1.1 percent, with volume discounts representing a good incentive for increased use). Further reductions in spread would not make the Fund much more affordable for banks and clients, but would reduce chances for cost recovery in 1998 (when the portfolio will be larger) and therefore reduce the chances for privatization.

A substantial reduction of operational costs of the Mortgage Fund is required to enhance its financial condition. Too many costs are charged to the Fund's expenditures as overhead from Bud-Bank's non-fund staff. A separation from Bud-Bank may also encourage modernization in systems and procedures. Expanded banking expertise is needed, including a strengthening of top management (supervising the commercial, legal,

[41] In a number of countries, refinancing operations similar to the Mortgage Fund are operated as trust funds by the Central Bank.

and financial aspects of banking lines, rather than checking the eligibility of individual housing loans as now). Preliminary simulations show that the Fund could achieve positive results in 1997 and 1998.

Finally, a home must be found for HFPO. Transference to NBP along with the Fund presents a logical solution. Given the continued need for technical assistance and training in construction and mortgage finance, HFPO's continued strength is important.[42]

3.3.4.4 Long-term Future of the Mortgage Fund

There are several options available for the Fund after 1998. If demand continues to be weak, the Fund can be closed and liquidated. If demand proves to be sufficient, the Fund could be privatized as a mortgage bank, funding itself through the issuance of mortgage bonds. Alternatively, it could be kept as a public refinancing agency to channel loans from the World Bank and other donors. A final option would be to continue operating the Fund as a public agency responsible for the overall implementation of the Mortgage Bank law and supervision of mortgage banks. The choice would be left to Polish financial authorities according to their view of the evolution of long-term financing of mortgage loans.

Privatization is an option that the GOP may wish to consider. Although many banks may not be borrowers today, they may value the option to borrow in the future. A group of banks could purchase the Fund from the GOP for the par value of the outstanding equity. The Fund could then operate as a jointly owned refinance facility for the banks or their mortgage banking subsidiaries.

The example of the Federal Home Loan Banks in the U.S. is instructive in this case. The Federal Home Loan Bank System (FHLBS) was created in 1933 to provide liquidity to home mortgage lenders. It was initially capitalized by the U.S. Treasury. Borrowers were required to become members and purchase stock as both members and borrowers. The system accumulated sufficient capital to completely repay the Treasury by 1947. Today, on a consolidated basis, the FHLBS is the third largest financial institution in the U.S. with combined assets in excess of $U.S. 275 billion.

One issue that must be addressed if a transformation to a mortgage bank is considered is the legal status of the Fund loans. The "subintabulat" issue concerns whether, under Polish law, the loans made by one financial institution (e.g., the Mortgage Fund), secured by a portfolio of loans made by another financial institution (e.g., a bank), are of sufficiently high quality to support a mortgage bond. The question is whether, in the event of failure of the borrowing bank, the Fund would be able to perfect its claim and obtain title to (and transfer the servicing of) the portfolio of loans so that such assets could be used to repay the mortgage bond investors**.**

[42] Since this report was drafted, the Ministry of Spatial Economy and Construction has apparently decided to discontinue the operations of HFPO, effective April 1997.

Centralized Refinance Facility: In this variant, the government would continue to own/control the Mortgage Fund, thus using it as an element of government policy. The advantage of this approach is that the Fund could issue securities that would be guaranteed (implicitly or explicitly) by the government. Such guarantees may be advantageous in developing capital market funding of housing. In addition, as a centralized bond issuer, the Fund would enjoy economies of scale in bond issuance and be better able than smaller private mortgage banks to maintain liquidity in its securities. The disadvantage is that it could crowd out the development of private mortgage banks.

Regulation and Supervision: The Fund is an institution experienced in the selection and standardization of mortgage portfolios and development of long-term bank refinancing. These skills will be important in the supervision of a private mortgage banking industry.

3.4 Developing Capital Market Access

3.4.1 Rationale

An important facet of mortgage market development, particularly for countries traditionally dependent on deposit-based funding, is the increased development of capital market funding. Not only does this source of funds expand the total flow of funds to housing, it facilitates improved risk management for lenders, an improved allocation of risk in the financial system, improved quality and standardization of the mortgage instrument, and increased competition in the primary mortgage market. The development of high quality mortgage securities can stimulate overall capital market development as well, by creating new and attractive investments for the growing institutional investor base.

Box 3.4
Capital Market Access and Mortgage Banking

- Dual circuit funding -- depository-based and capital market funding -- is increasingly important in many countries: U.S., U.K., Germany, Canada, Australia, and others.
- Capital market access has three major mechanisms:
  - The Mortgage Banking Model, utilizing special mortgage bonds (Germany, Denmark, others)
  - The Securitization Model: mortgage-based securities (the U.S., especially; also the U.K., Australia, and Canada, with first steps being taken in many other countries)
  - Refinance Model: liquidity/rediscounting (U.S.: FHLB System; France: CRH)
- Capital market access in Poland's future:
  - Both the Mortgage Banking Model and the Refinance Model may be operative in Poland.
  - A future where both universal and mortgage banks exist could prove very beneficial.
  - **The playing field must be level for all institutions:**
    - "Special Privilege" funding is being dismantled worldwide.
    - Fair competition is crucial.

Box 3.4 summarizes several types of capital market access and the probable future structure in Poland.

The institutional investor base in Poland is growing rapidly. There are 41 insurance companies licensed for business in Poland, but the market is dominated by three institutions: PZU Zycie, with an 87 percent share, Commercial Union, 6.5 percent, and Amplico Life, 4.6 percent.[43] Total sales of life insurance have grown from PLN 887 million in 1993 to PLN 1,852 million in 1995. Life insurers invested over PLN 2.1 billion in the capital market in 1995. At the end of 1995, insurance company portfolios consisted of 47 percent in bank deposits, 25 percent in T-Bills, 15 percent in equities, and 13

[43] Source: *Review of the Status of the Polish Capital Markets*, Financial Services Ltd., 1996.

percent in other investments. Given the long-term nature of life insurance company liabilities, they are likely to have substantial interest in a secure long-term investment option.

There are not yet private pension funds in Poland. Many companies offer employees an investment trust retirement program marketed by Pioneer First Polish Trust Fund; its assets of PLN 674 million are invested 37.6 percent in equities, 61.5 percent in Treasury securities (of which 9.5 percent is in Treasury Bonds) and 0.6 percent in foreign securities.[44] Also, four mutual funds have recently been licensed to operate in Poland.

3.4.2 Alternatives

Mortgage Bank Model: There are a number of mechanisms by which capital market funding can be accessed for housing. The oldest mechanism, which actually originated in Poland during the mid-1700s, is the mortgage bond model. The mortgage bond system involves a number of specialized mortgage banks that originate mortgages (in competition with commercial banks and other lending institutions) and finance themselves through the issuance of bonds collateralized (backed by) the mortgage loans. The mortgage loans remain on the balance sheet of the lender and the bond investor has preferential rights to the collateral (as well as to the capital of the mortgage bank) in the event of failure. The mortgage bank model is a major component of the French, German, and Scandinavian mortgage markets.

Securitization Model: Although mortgage bonds are mortgage-backed securities, the more common use of the term refers to instruments that are backed solely by the cash flows of an underlying pool of mortgages. Securitization in this sense refers to the sale of the mortgage assets with a transfer of credit risk to the buyer and thus represents an off balance sheet form of finance. Mortgage-backed securities in this model can be issued directly by mortgage lenders (banks, mortgage banks, savings institutions) or by conduit institutions that purchase mortgage loans from primary market lenders and fund themselves through the issuance of securities. The securitization model is a major aspect of the U.S. system, which is dominated by government-sponsored conduits, Fannie Mae and Freddie Mac, and a government agency, Ginnie Mae. Securitization is also a part of the housing finance systems of Australia, Canada, and the United Kingdom, and is now being introduced in a number of other countries.

Refinance Model: In many countries, purely wholesale institutions exist to facilitate the flow of funds to the primary mortgage market. These institutions, referred to as liquidity, rediscounting, or secondary mortgage facilities, are typically government owned or supported. They issue general obligation bonds in the capital markets and use the proceeds to refinance the portfolios of primary market lenders. In the U.S., the Federal Home Loan Banks have been making collateralized loans to mortgage lenders since the 1930s; also, as noted above, the FHLBS was purchased by its members over a period of about 14 years. In France, the Caisse de Refinancement de Hypothécaire (CRH) performs a similar function.

[44] Source: op. cit.

3.4.3 Review of the Proposed Mortgage Bank Law

3.4.3.1 Description

The current draft mortgage banking law would permit the creation of specialized mortgage lending institutions that would have exclusive rights to issue mortgage bonds collateralized by their mortgage loans. The legislation is inspired from the German model and has its roots in the creation in 1770 of the Silesian "Landschaften."[45] Mortgage bond systems have been very effective in generating stable, long-term funds for housing in a number of countries. Similar laws have recently been introduced in the Czech Republic and Slovakia. The intent of the legislation is to provide for the creation of intermediaries that can tap the growing quantities of long-term funds held by institutional investors (insurance companies and pension funds) to provide long-term loans for housing.

The major points of the draft legislation include the following:

- The mortgage banks will be joint stock companies (either independent or subsidiaries of other financial institutions).

- A narrow range of activities (mortgage and government lending), assets (mortgages and government securities), and funding (mortgage bonds and interbank debt) will be permitted.

- Supervision will be undertaken by National Bank of Poland and an outside trustee (on behalf of the bondholders).

- Mortgage credits financed with mortgage bonds may constitute only up to 60 percent of the value of the real property constituting the mortgage security and maximum loan-to-value ratio loan of 80 percent (the cover). Other assets (e.g., government bonds) can only comprise 10 percent of the mortgage bond cover.

- Synchronization will exist between the terms of mortgage loans (fixed interest period) and bonds with the ability to exclude early repayment during the fixed interest period.

- Matching of the nominal value of the mortgage bonds in circulation and mortgage loans as collateral and interest income and expense will occur.

- The maximum leverage ratio will be 40:1 (equity-assets of 2.5 percent).

3.4.3.2 Issues

There are a number of issues that should be addressed when considering passage of the draft legislation. These include the role of the new intermediaries in the evolving Polish financial system, the incentives given to the new institutions, their likely commercial viability, and the risks they may pose to the Polish government.

[45] See Pleyer, 1987.

Specialization: The creation of specialized financial institutions represents a change of course in the development of the banking system in Poland. Heretofore, the emphasis of the government and financial system regulators has been on the development of universal banks of a scale necessary to compete on a pan-European basis. This emphasis is consistent with global trends in housing finance in which generalized financial intermediaries such as commercial banks are increasingly important providers of housing finance, often at the expense of older special circuits.[46]

The Polish mortgage market is at a nascent stage of development. Commercial banks are just beginning to enter the market. Although they have concerns about the liquidity risks of long-term housing finance, they appear to have decided to invest in the infrastructure necessary to make a significant volume of such loans in the future. The option of financing with mortgage bonds (and eventually mortgage-backed securities) is one they have great interest in, as it provides them with access to long-term funding. The primary question is whether it is better to issue such bonds directly or through specialized mortgage banking subsidiaries.

There are pros and cons to the creation of specialized housing finance institutions. On one hand, specialized institutions can be more transparent and easier to supervise. Creation of a number of specialized institutions also can increase competition in the mortgage market. On the other hand, such institutions lose the benefits of diversification and may be riskier due to their concentration in one volatile sector of the economy.

The passage of the Mortgage Bank Law and creation of mortgage banks would in no way preclude the formation of a true secondary market with sales of mortgages and mortgage-backed securities. Both commercial banks and mortgage banks could package loans into securities and sell them to institutional investors. Such sales currently would be very difficult because of the complexity and lack of standardization of mortgage instruments and the lack of performance histories of mortgage lenders. The mortgage bonds issued by mortgage banks will be much simpler than mortgage-backed securities. In addition, because there is no direct transfer of the mortgage credit risk (the bonds will be obligations of the mortgage bank backed by the capital of the bank as well as its assets) they are more likely to be purchased by investors.

Ultimately the issue of whether to create specialized mortgage banks should be decided by the market. If investors prefer to purchase bonds from regulated, specialized, and transparent institutions, then they will pay higher prices (with concomitant lower required yields) for such bonds from mortgage banks (as opposed to commercial banks). The primary issue is whether such institutions should have any special advantages over their competitors.[47]

Incentives: The draft legislation contains a proposed fiscal treatment in which bond interest would have full tax deductibility for corporate and individual investors. This treatment would result in a superior tax treatment for private mortgage bonds relative to government securities and municipal bonds.[48]

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[46] See Diamond and Lea, 1992, and Renaud, 1996.

[47] This works in both directions. State owned banks that operate with government guarantees can possess significant advantages over purely privately-owned institutions.

[48] Prior to 1997, the interest on government bonds was exempt from taxation for individuals. This preference was eliminated at the end of the year.

At issue is whether such favorable treatment is necessary to create the market and what the likely cost is going to be for the Government. In the early stages of market development, it is important for the mortgage bonds to have comparable characteristics to government bonds, the main alternative fixed income investment. ***There is no reason to give mortgage bonds a preference over government or municipal bonds.*** Such a preference is tantamount to saying that private housing is a more important social investment than government projects, social welfare expenditures, or municipality infrastructure investments. It is also important to note that ***tax exemption of interest on mortgage bonds is a poorly targeted fiscal incentive*** (the value of the deduction rises with the marginal tax rate of the investor) and lacks accountability and transparency. The lack of accountability derives from the fact that the deduction will not go through the annual budget process and the lack of transparency derives from the fact that it is not easy to identify the ultimate beneficiaries of the subsidy (as it is shared among investors, borrowers and issuers).

Tax exemption of mortgage bond interest can be costly. In developed countries, the ratio of mortgage debt to GDP ranges between 25 and 60 percent and in many developing countries the ratio is between 10 and 25 percent.[49] If, in a few years, mortgage loans outstanding reach 10 percent of GDP in Poland, and 30 percent of loans are funded by mortgage bonds, the ratio of bonds outstanding to GDP would be approximately 3 percent.[50] At an average annual interest rate of 15 percent and an average tax rate of 33 percent, the annual revenue loss would be over PLN 500 million, or 0.14 percent of 1996 projected GDP. This compares with a budget for the National Housing Fund in 1996 of PLN 120 million, for the Mortgage Fund of PLN 50 million, and a total housing budget of PLN 4 billion..

The proposal to exempt mortgage bond interest from taxation is unnecessary and potentially highly distortionary. In the current interest rate environment, the exemption would create a large potential interest rate differential between mortgage bonds and government and municipal bonds (e.g., up to 38 percent of 20 percent or 7.6 percentage points). A subsidy of this magnitude can be quite costly (in terms of lost tax revenue) to the government. It is also out of proportion to the need to stimulate bond purchase. It is likely that well structured mortgage bonds will be attractive investments for mutual funds, insurance companies, and banks without the tax exemption. These investors are desirous of diversification alternatives to government bonds. Furthermore, the introduction of mortgage bonds may coincide with the creation of pension investors under the proposed pension reform initiatives. These investors should also find mortgage bonds to be attractive assets.

The tax exemption may be distortionary if given only to mortgage banks. These banks could have a significant cost of funds advantage over other providers of mortgage credit, potentially driving such providers out of the market. With less competition, it is possible that little or none of the subsidy would actually benefit borrowers, as it would instead be captured by the banks. One likely scenario is that one or more large commercial banks would create a mortgage bank subsidiary, purchase the bonds issued by the subsidiary for its own account, and thus capture most if not all of the subsidy. **If the Ministry of Finance goes forward with this proposal, it should limit the tax exemption to bonds issued publicly and not purchased by parents of mortgage banks.**

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[49] For example, the mortgage debt to GDP ratio in Denmark is over 100%, in the U.S. it is 54%, in the U.K. it is 56%, and in Germany 49%. Among developing countries, in Chile it is 17%, in Malaysia 23%, and in Mexico approximately 10%. See Lea and Bernstein, 1995.

[50] In Denmark, which is the extreme example of mortgage bond funding with over 90% of all mortgage loans funded through the issuance of mortgage bonds, the volume of bonds outstanding is equal to 95 percent of GDP. In Germany, mortgage bonds outstanding are equal to 10 percent of GDP.

The current draft incorporates a sunset for the provision at the end of five years. However, a subsidy of this magnitude will be difficult to eliminate at the end of five years. Elimination would introduce a potentially large increase in the cost of funds of mortgage banks, reducing their competitiveness. It is likely that both the banks and investors would lobby hard for a continuation of the subsidy. If the MOF goes forward with this proposal, it should consider capping the subsidy (e.g., tax bond interest at a lower tax rate but do not give a full exemption) or phasing it out gradually over the 5-year time period. This approach would allow the market to adjust more easily to its elimination.

The other proposed preference concerns the ***mortgage lien priority.*** The Draft proposes a privileged ranking for a Mortgage Bank mortgage at foreclosure over liens of other banks (at the same ranking as tax authorities). This solution does not solve the underlying legal problems (i.e., that the regulatory mortgage can be registered at any time, and there is no general priority ranking of lenders). The proposed solution would create distortions between different types of banks and their use of mortgage collateral. This provision ***should be expanded to all banks undertaking mortgage lending.***

Centralized (Refinance) Option: The design of the law envisions bonds issued by a number of independently operating mortgage banks. However, smaller banks may not wish to bear the costs of forming a mortgage bank or the yield premium associated with infrequent and small-volume bond issues. In this case, a centralized bond issuer that could refinance such banks could be useful. Securing assets could then include some refinancing banking credits, which would secured in addition by a portfolio of identified mortgage credits (meeting all the Mortgage Bond Law's legal requirements). A centralized lender would not directly originate mortgage credits, but would exclusively issue bonds and refinance various primary banks. This bank could register its mortgage rights through including a sub-subintabulat requirement in the refinancing contracts.

A number of Polish banks (notably smaller ones) could then create such instrument(s) together. The banks would contribute equity to, and thus have ownership shares in, the facility. This variant could be cheaper for them than issuing their own bonds (both in issuance cost and in creating liquidity in the instruments). The ability to access the capital markets through issuance of mortgage bonds can stimulate increased competition in the mortgage market. The facility could issue higher quality bonds (through portfolio diversification) and spread the fixed cost of minimum capital requirements among a number of institutions.

The German mortgage bond system is a *de-centralized* system in which a number of mortgage banks compete aggressively without government assistance. The rigid legal structure and high degree of supervisory oversight eliminate the need for a government guarantee. By comparison, the U.S. system is a *centralized* system in which two large government-backed conduits, Fannie Mae and Freddie Mac, and a government agency, Ginnie Mae, dominate the market. Government backing was important in creating the market but almost all experts agree that such support is no longer needed. However, once in place, government support is difficult to eliminate as both the conduits and the housing industry trade groups aggressively work to maintain the status quo. Likewise in France, the mortgage bond market was dominated by one centralized institution with government backing, the Credit Foncier.

The primary issue is not centralization versus de-centralization but whether the centralized institution is government backed or not. In the Polish context, de-centralization and private acceptance and management of risk are important characteristics to instill into the system. The mortgage bond system is more likely to achieve these objectives than the U.S. system. A U.S. style secondary market may need a government sponsored conduit to purchase and standardize the market, since it is not likely at the present time that investors would buy mortgage-backed securities directly from banks due to their complexity and lack of standardization. In essence, this transfers the credit risk of mortgage lending to the government, which is not healthy in an emerging market like Poland.

There are a number of legal issues that need to be addressed to ensure that the centralized institution has rights to the collateral in the event of bank failure. In particular, the facility must have the right to transfer servicing and ownership of the mortgages without going through a bankruptcy procedure. One way this issue may be addressed is by requiring participating banks to create mortgage bonds that would be held by the centralized institution. This proposed separation of the refinancing function from the origination/servicing functions of credits has been successfully developed in Switzerland and in France (Caisse de Refinancement Hypothécaire). The Mortgage Fund could also be privatized in such a way at the end of 1998.

3.5 Contract Savings for Housing

3.5.1 Rationale

Contract Savings for Housing (CSH) systems originated in Germany after World War I (the *Bauspar* system) and were revived in that country and in Austria before also developing in France (*l'Epargne Logement*) after the second World War as mechanisms to address the financing needs of the housing sector. The current attractiveness of CSHs stems in part from parallels that can be drawn between the economic, financial, and housing market conditions that existed in Western Europe after the War and those that prevail today in transition countries: an absence of long-term savings, a perceived housing shortage, affordability problems as evidenced by high price-to-income ratios, high and volatile inflation, reduced real incomes, and a lack of banking information on households and properties. CSH programs have recently been started in the Czech Republic, Hungary, and Slovakia.

CSH contract instruments used in Continental Europe derive from the early U.K. experiences with mutual forms of housing finance. They involve a contract on the part of a household to save an agreed amount over a prescribed period in return for a commitment on the part of a financial institution to provide a loan, at pre-specified terms, for the purchase or renovation of owner-occupied housing. Traditional CSHs are characterized by fixed, below-market interest rates on both the savings and the subsequent loans. By design, CSHs attempt to insulate households from financial market volatility. An important part of the appeal of these systems lies in the promise of eventual loan availability at a predetermined rate of interest.

CSH systems have had a very significant degree of success in post-War Europe. They address two of the most vexing issues confronting transitional economies today: lack of adequate information on borrowers and on properties to assess and manage credit risk, and lack of long-term funding for housing. By saving regularly over an extended period of time, a household evidences financial responsibility which may signal reduced credit risk. The savings form a pool of long-term funds for down payments and long-term loans.

3.5.2 Alternatives

The characteristics and behavior of the German and the French CSH systems differ. The most important difference is that the German system is "closed" and the French system is "open." As a closed system, the German model follows a strict principle of mutuality and transparency. CSH deposits are mobilized by a specialized institution, the *Bausparkassen*. These funds are only available to make loans to participants. In case the funds available are not adequate to meet current CSH loan demand, participants will be served according to well-defined queuing rules. The timing of granting the loan is thus determined by institution. This closed circuit is generally isolated from the capital markets, although Baursparkassen can supplement their resources through deposits from other financial institutions. The German system contains modest tax incentives that are capped in amount to ensure a degree of targeting.

The French system was inspired by the already established German system. However, the original closed French system was deliberately modified by 1970 into an "open" system aimed at creating a tranche for savers who would be willing to leave their savings in the CSH system without exercising their loan rights, because they found the yield on their savings attractive. The "free funds" so generated could be used by deposit institutions to fund other types of housing loans or invest in the mortgage bond market. Finance Ministry authorities have kept CSH deposit rates competitive (on an after-tax basis) with alternative savings vehicles in order to expand the savings pool and attract many non-borrowing savers ("*les bon frères*" or the good brothers). The French system is therefore an *open* system. Because these funds support a variety of lending purposes, and loans are available immediately after completion of the minimum savings period, they are issued by general banking institutions with extensive branch networks and alternative funding capabilities.

3.5.3 Review of New Contract Savings Law

Poland has introduced a contract savings system together with the establishment of the National Housing Fund (NHF). As discussed in detail in Chapter 5.0, the National Housing Fund will lend to not-for-profit housing projects, such as those established by TBS (the social housing associations), and rehabilitation and municipal infrastructure projects. The NHF will also provide a liquidity facility to the contract savings institutions. The NHF is operated by Bank Gospodarstwa Krajowego (BGK) and supervised by the Finance Ministry. The operations of the NHF in terms of policy directions are supervised by the Housing and Urban Development Office. Supervision of the liquidity aspects of the contract savings system will be performed by the National Bank of Poland; the NBP will issue ordinances concerning accounting and reporting regulations. Individual savings in the system are treated as deposits and are subject to the federal deposit insurance program to the amount of PLN 32,000 ($U.S. 11,500). Funds accumulated in the system are not subject to NBP reserve requirements; however, the funds cannot be used by operating banks for other (than statutory) purposes, and may be invested only in government securities.

The contract savings program is to be operated by existing financial institutions, which must create separate functional and organizational units for this purpose. So far only one bank, PKO SA, has started a contract savings program (in the fall of 1996), although other commercial banks have also expressed interest.[51] The saving period must be at least 3 years with the possibility of shortening it to 2 years if the saver has already accumulated savings in the former housing pass-book system.[52] The savings rate must not be less than 2 percent or 0.25 of the NBP rediscount rate (for November 1996 this means a rate of 5.5 percent given the NBP rediscount rate of 22 percent). The lending rate must not be not less than 4 percent or not more than 0.5 of the NBP rediscount rate (thus, 11 percent in November 1996). After the saving period is completed, the

[51] Bank Śląski, Powszechny Bank Gospodarczy, Bank Depozytowo-Kredytowy, Bank Przemysłowo-Handlowy, and Polski Bank Inwestycyjny have apparently expressed interest.

[52] The PKO SA has decided not to allow the shortening of the saving period in their contract savings program.

bank has one month to notify the contract saver about the entitlement to apply for a housing credit. The savings contract may also be extended upon application by the saver to amend the contract.

Although not modeled precisely after either the German or French system, Poland's system appears to be a modified "closed" system. Savers are expected to be able to borrow at the expected time period. As discussed below, if the system temporarily loses its liquidity, the participating bank will be able to borrow from the NHF. If that proves insufficient, borrowing will be arranged according to seniority principles, similar to the German system.

The legislative provisions do not specify the length of the housing credit; the repayment period can be as short as the savings period, however, making it difficult for many households to afford.[53] The law is also silent on the service fees to be charged by the operating banks, which may lead to increased costs for savers if tax benefits are generous.[54]

The contract savings for housing (CSH) system encourages people to enter the contract savings program because of particularly strong tax incentives.[55] In 1996, the amount saved for the year was deductible from the taxable income; apparently, tax regulations will change in 1997 to allow deductions from taxes owed and not income earned.[56] The plans for fiscal year 1997 indicate that high income households, using the full amount of tax deductions, should be able to earn a rate of return of 34 percent per annum, which is superior to other forms of saving. **In addition they retain at the same time the right to take a low-interest-rate loan in the future.[57] Households withdrawing from the contract savings program may retain tax benefits if the money is used for other housing purposes.**

If the contract saver decides to borrow, the bank has 3 months to grant the loan, but the loan may be refused on grounds of creditworthiness problems of the saver or lack of appropriate collateral as deemed by the bank.[58] The saver may terminate the contract before the completion of the contracted period. In this case the saver receives the saved amount plus accumulated interest. If the saver decides not to take a loan after the saving period has been completed, he receives the accumulated savings plus interest for the entire savings period,

[53] This is happening with the PKO SA program, which offers a loan period of the same duration as the saving period. In a high inflationary scenario the benefits of such a loan are drastically reduced and emphasize the value of tax relief to high income households.

[54] In the case of the PKO SA program, the bank charges a 1.8% fee on each deposit and late payment fee of 2.8%. In this way, the bank is essentially able to capture some of the tax benefits conferred to savers.

[55] The PKO SA contract savings program is marketed mainly as a strong tax relief instrument for the higher income households, especially for 1996 when savers will be able to deduct PLN 12,880 from their taxable incomes, which will save up to PLN 5,796 for high income bracket households.

[56] According to PKO SA information, in 1997 some 30% of contract saving deposits can be written off from the tax amount and not from the taxable income. There are to be limits on absolute amounts deductible from taxes expressed as 6% of the amount declared by the Office of Housing for the use of housing guarantee premiums for a given year, and in total not more than 20% of that declared amount could be deducted from taxes in the program. These changes will reduce the regressivity of the system as the value of the contribution write-off is no longer a function of the household's marginal tax rate. The interest income on the savings is tax exempt and the value of this benefit (which is much smaller than the contribution credit) still varies with income.

[57] PKO SA calculates that the allowable tax deduction for 1997 will be on the order of PLN 4,500. If the household accumulates the amount of PLN 15,000 in 1997 and does not pay tax advances to the treasury, the effective interest will amount to 34% per annum.

[58] This gives extensive power of refusal to the bank. The PKO SA agreement mentions collateral such as personal guarantees, registered bank liens, mortgages on real property rights and interests, or any other form acceptable to the bank.

calculated as one half of the interest paid by the operating bank on its one year deposits. The saver may also transfer the contract savings account to the next of kin.

As noted above, in order to maintain its liquidity, the operating bank will be able to borrow from the National Housing Fund. If that proves insufficient and the system temporarily loses its liquidity, the granting of mortgage loans will be arranged by principle of contract seniority.[59]

3.5.3.1 Household Perspective

Households can use the system to accumulate equity down payments and secure low rate loans. This provides households with the incentive for discipline in saving and budgeting habits thereby obtaining "credit worthiness" through a proven savings track record in a specific financial institution. Since a contract savings system in most cases generates only a portion of the funds needed to purchase a house, this could prove to be an important impetus to underwriting additional loans in the CSH bank or even another institution.

Table 3.3
Contracting Savings Assumptions

Initial Savings Account		
Target Home Purchase Price	50,000	
Savings Target % of Price	31.5%	
Loan Multiple of Savings	150%	
Savings Target Amount	15,750	
Contracted Loan Amount	23,625	
Gross Annual Income	18,000	
Savings (% of Gross Income)	20%	
Savings/month	300	
Government Contribution/month	100	
Total Savings/month	400	
Savings Interest Rate	5.00%	per year
Length of Savings Period	36	months

From the household perspective, the important issues are the role CSH can play in home purchase and the overall cost of the contract. In the current economic environment in Poland, the CSH system can contribute perhaps one-third of the total resources needed to purchase a house. Table 3.4 shows a simplified contract for a household wanting to save 20 percent of its income for three years in order to purchase a PLN 50,000 house. The savings target is 31.5 percent of the house price and the loan/savings multiple is 1.5. The tax savings are assumed to equal one-third of the savings contribution.

[59] In this manner, the Polish system resembles a closed system, with some uncertainty as to the timing of having the loan disbursed to the would-be borrower.

If the inflation rate and the market savings rate are both assumed to remain constant, at 15 percent, and the market mortgage interest rate is assumed to remain constant, at 20 percent, at the end of the three-year savings period, and a six month additional waiting period, the contract loan would represent only 29 percent of the house price and the contract savings down payment only 19 percent (Table 3.4). Thus the saver needs additional funds (an additional loan, for example) of PLN 41,978 to purchase the house (or PLN 42,375, not counting the extra savings of PLN 397). The reason for the percentage decline is the inflation-induced increase in the price of the house. Savers who enter into contract savings system must also take into account the opportunity cost of the below-market savings during the savings and waiting period as well as the value of the below-market-rate loan. In this simple example, the all-in borrowing rate turns out to be 19.6 percent, only slightly better than the assumed market rate of 20 percent. Thus, the system is sensitive to inflation.[60] If inflation and market interest rates decline, the contract loan can finance a larger portion of the house price reducing the need for additional financing (but also reducing the value of the below-market-rate financing). Given the magnitude of the funds involved, the CSH may be more useful for financing home improvements -- an urgent priority in Poland.

Table 3.4
Contract & Additional Loan After Waiting Period

House Price after Waiting Period	81,750
Contract Savings Down Payment	15,750
Excess Savings (for extra down payment)	397
Contract Loan Balance	23,625
Deficient Amount - Tertiary Financing	41,978

60 The German system, too, provides only a portion of the amount required to purchase most dwellings. However, the system has proved stable under Germany's circumstances of stability in inflation. In Poland, the impact of inflation, and changes in the rate of inflation over time, warrant observation.

3.5.3.2 Lender Perspective

Financial institutions involved in the contract savings system may see benefits in establishing reliable track records and financial discipline of potential future clients, not only for housing credit, but for other products as well. The system helps solve the problem of mismatch between short-term deposits on the funding side and long-term mortgage loans on the lending side, since contract savings create a medium-term source of capital, thus bridging the term structure. The banks using this system will earn substantial profits from the investment of the savings in government securities during the early years of the program. The liquidity risk is borne by the Housing Fund and thus does not threaten the stability of the bank. Finally, as seen in the example of PKO SA, lenders may charge substantial fees to administer the program.

3.5.3.3 Government Perspective

Governments supervising the operations of the contract savings system must worry about liquidity and about efficiency in mobilizing private savings of targeted social groups. Subsidies and tax benefits, once offered, are difficult to withdraw. With the generous tax benefits now offered by the CSH, the government may face a significant budgetary problem as this program grows. There appear to have been no calculations of the potential impact of the system on tax revenues.

The government also faces a significant **contingent liability** in the event that the systems do not continue to grow as expected, and lenders find themselves with insufficient funds from new savers and repayments of existing borrowers to meet the demands of new borrowers. The Housing Fund is the liquidity provider for the CSH, which exposes TBS housing finance to the liquidity risk of the middle income home finance system. If the National Housing Fund has insufficient resources, the NBP may have to intervene.

3.5.3.4 Issues

As noted above, the CSH system has been effective in mobilizing funds in France and Germany. **However, even in these countries the system has been almost exclusively used for supplemental credit.** In addition, the context for its development in those countries was different from that of Poland. The German system was restarted after the War with large tax incentives as part of a directed credit system (along with mortgage banks) that was supported so that commercial banks could provide commercial and industrial finance to rebuild the country. The French system was started in the 1960s as a more efficient form of subsidy (relative to production support).

One risk of the CSH system in Poland is that it may be oversold. As shown above, **it is highly unlikely that a contract savings system can be a primary source of mortgage credit for households.** If households enter into the contract with such expectations they may be severely disappointed when it comes time to get a loan and purchase a house. The current practice of limiting the term of the credit to the term of the savings contract also serves to limit the portion of the house that can be financed through the CSH.

A second issue is the size and distribution of public support. The early purpose of the contract savings system -- stated in various political declarations -- to address the affordability problems of medium-income households, seems to be still some years away. The present beneficiaries of the tax relief regulations are higher income households who are also likely to be able to obtain market mortgage loans in order to finance their housing investments. In fact, the system may be assisting higher income households with a release of extra funds (saved on subsidies) for consumption other than housing, most notably automobiles, which are being bought in Poland at record rates. Closer targeting on middle-income households and those households that cannot obtain market rate mortgage loans at present should be considered; for example, the German system places a cap on the level of tax benefits, which at least reduces the degree of regressivity (that is, favoring higher income households relative to those of moderate income).

A third issue is the potential liquidity risk in later years of the operation of the system, when credit borrowing will begin to grow and new entries into the system may slow down, especially if tax benefits are reduced. This requires further discussion and simulations on the one hand, and more active supervisory role of the government on the other hand. The keeping of the refinancing facility for the system together with the TBS program attached to the National Housing Fund will need to be revisited, as there is no obvious connection between the TBS and contract savings programs. Policymakers should not want to see a diminution in the funds going to the former program, to deal with problems occurring with the latter.

While subsidized contract savings can serve to mobilize private resources into the financial system, there remains an issue as to whether these savings could be mobilized more efficiently in a broader contract savings systems of pension funds and life insurance companies, which seem to be more important for macroeconomic development.

Thus, in summary, there seems to be a need to clarify more strongly the objectives of the contract savings program and relate it to other government initiatives such as the Mortgage Fund and mortgage banks and bonds.

3.6 Conclusions

The slow progress in the development of a market-based housing finance system in Poland is not surprising. The demand for mortgage credit has been slow to develop due to the extreme uncertainty of households about both their future incomes and house prices as well as a depressed relative price of rental housing and high housing price-to-income ratios. The supply of housing finance has also been slow to develop, reflecting the legal impediments of the old socialist housing system and the need to develop new lending instruments and operations. If the draft Mortgage Bank legislation is passed and other recent housing finance initiatives proceed as expected, the Polish housing finance system will have a significantly different character by the year 2000. The biggest change will be a significant increase in the volume of private sector funds.

At this point in development, the housing finance system in Poland can develop in one of several ways. The understanding of these alternatives is important for policymakers to consider, as their decisions about the future of institutions like the Mortgage Fund depend in part on which vision of the future they hold. The two major alternatives for development at this time are as a depository-dominated system or as a specialized lending, bond-financed system.

A depository-dominated system would feature lending primarily, if not exclusively, by commercial banks. These institutions would issue variable rate mortgages funded primarily by deposits.[61] The need for wholesale funding in this system will depend on the share of housing credits in the overall portfolios of the institutions and their capital adequacy. As the share rises above 10 percent to 20 percent, depository institutions typically look to the capital markets for long-term finance to help them manage liquidity risk. If lenders are capital-constrained, they look to off-balance funding techniques like securitization to facilitate balance sheet management and continued lending.

The Mortgage Fund can play a constructive role in a depository-dominated system as a liquidity and long-term funds provider. The Fund can help depository institutions access the capital markets more efficiently as a centralized bond issuer. This role will be particularly useful in supporting smaller banks and keeping the mortgage market competitive.

The major risk in a depository-dominated system in Poland could be lack of competition among lenders. The current system is still dominated by PKO BP, which enjoys a certain advantage due to its historical role as collector of household funds and housing lender. A risk to the system would be evident, for example, if PKO BP marketed very aggressive DIM designs with low starting rates. It would be very difficult for other institutions, particularly smaller banks and nascent mortgage banks, to compete with such an instrument. In reality, however, competition to PKO BP from other banks has already been well established (as discussed in Sections 3.1 and 3.2), so this risk scenario may have little relevance at the present time.

The major alternative scenario for the development of the system is through mortgage banking. In such a system, the dominant source of funds will come from the capital markets. The key issue in developing such a system is the safety and soundness of the banks and the bonds. Issuance of bonds that are not properly collateralized or supported by strong lending institutions can endanger the development of the capital markets and institutional investors. A mortgage banking system is more likely to see the development of fixed rate mortgages, as the risk of fixing the rate on the mortgages can be better borne by institutional investors than by depository institutions. In this system, the role of the Mortgage Fund is less important, as individual mortgage banks will access the markets directly. Its future in this scenario may be as a mortgage bank jointly owned by several banks.

The development of these two systems is not mutually exclusive. As long as there is a level playing field and continued development in the legal and regulatory protection of the mortgage instrument, there is no reason why depository institutions and mortgage banks cannot compete effectively. In fact, joint development of the two systems (as in the case of France and Germany) can facilitate increased competition and product selection for consumers.

Thus, our recommended institutional structure for the future evolution of the housing finance system (Figure 3.2) shows both systems. The new entrants are the Mortgage Banks, which obtain funding from institutional investors. Both the Mortgage Fund and the National Housing Fund can obtain funds from the capital markets as well. If this link develops, it will allow a more targeted use of scarce resources by GOP. The development of a mortgage bond market can facilitate the mobilization of private sector resources by the Housing Fund as a lender to the gminas, and the Mortgage Fund as a centralized private refinancer of both banks and mortgage banks. The contract savings system provides supplementary loans. The GOP assists housing through a variety of mechanisms, including the National Housing Fund, the proposed Renovation Fund, and funds for housing-related infrastructure. (Please refer to Chapter 5.0 for a discussion of public housing finance and the manner in which it supplements private finance and is linked to it via public/private partnerships.)

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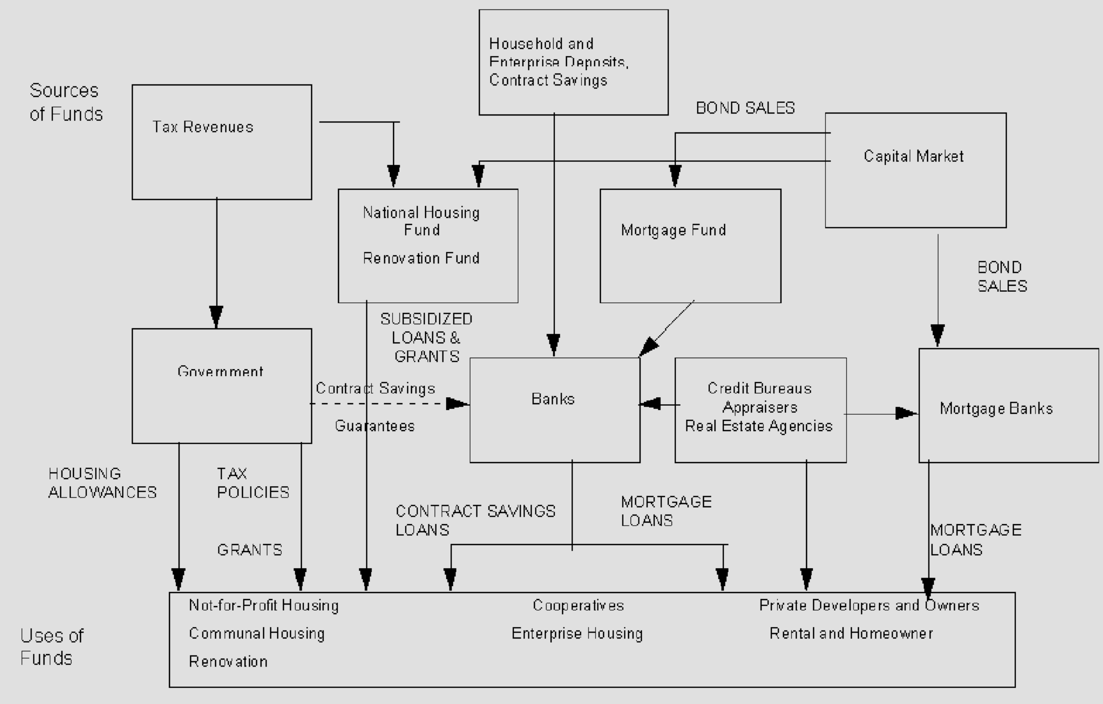
[61] In the short run, alternative instruments like the DIM will continue to be important. As inflation and nominal interest rates fall, the need for such instruments will also fall and lenders will probably begin using simpler instruments.

Figure 3.2
Polish Housing Finance System: 2000



In summary, the housing finance system in the year 2000 hopefully will (1) capture the benefits of a "dual-financed system": depository and capital market, allowing maximum competition via a "level playing field" approach; (2) have provision for refinancing and/or securitization in the long-term; (3) encourage savings for housing through the CSH, which would offer a supplementary source of credit; (4) have developed a number of modes of capital market funding (for example, mortgage bonds, municipal bonds, bonds of the National Housing Fund); and (5) be able to leverage public sector funds through public/private modes of cooperation and funding.

4.0 LEGAL ISSUES IN HOUSING FINANCE

4.1 Background

Lenders look at the strength of the legal framework to evaluate their credit risk in making a mortgage loan. If the framework is weak, banks must compensate for the increased risk by increasing the cost of the loan to the borrower. If the risk is very great, lenders may be forced to charge such high rates of interest that the loans become unaffordable to most people, or may refuse to make mortgage loans at all. Thus, a legal system designed to assure that mortgage borrowers repay their loans, and to protect the interests of lenders if they do not, helps make credit available and affordable for as many people as possible.

Prior to the economic transition in Poland, as in the rest of Central and Eastern Europe, financial terms for housing loans made by the state or state-owned banks were soft, with long repayment terms and deeply subsidized interest rates. Lenders making residential loans did not rely on the property itself as security for the loan in case of default, but were far more likely to use remedies such as garnishment of the borrower's wages or collection from guarantors by garnishment of their wages. Because the lender was the state, and the largest employer was the state, there was essentially a closed system in which wage garnishment was quite effective in collecting from a borrower in default. Although pre-transition law enabled a borrower to use his property as collateral to secure a housing loan (in other words, mortgage lending was a legal possibility), true mortgage financing was not necessary and rarely used. In addition, other pre-transition laws, regulations, and firmly entrenched practices made security for true mortgage lending so weak as to be simply not feasible.

Since 1989, Poland, like the other CEE countries in transition, has embarked on a program of legal reform to make market-based housing finance a reality. The necessary legal framework, and Poland's current position along the continuum toward that goal, are analyzed in this chapter.

4.2 The Legal Framework for Housing Finance in Poland

To evaluate the legal framework for mortgage lending in Poland, it is necessary to evaluate enabling laws, which allow real estate to be used as collateral for a loan; real property registration laws, which provide evidence of the lender's security interest; and enforcement laws, which give the lender the right to take possession of the collateral and sell it to satisfy the debt if the borrower defaults. An important subset of enforcement laws is the regulation of foreclosure and eviction.

4.2.1 Enabling Laws

Enabling laws provide for two fundamental principles of mortgage lending: they give an owner of real estate the ability to pledge his property as collateral to obtain a loan, and they give the lender rights in the mortgaged property that secure the lender's claim for payment of the debt. Mortgage security derives from the lender's right to place a lien on immovable property, and to seize and sell the property if the borrower defaults in repaying the loan.

In Poland, these essential elements are adequately provided in the 1982 Law on Perpetual Books and Mortgages.

4.2.2 Registration Laws

Laws relating to creation and administration of a system for real property registration provide for records demonstrating ownership or title, and the existence of other interests or property rights affecting the real property, including mortgages, other liens, easements, and the like. In Poland, property records do not merely indicate ownership or other facts about real property; they constitute legal evidence of ownership and the existence of other interests, including a lender's security interest.

In order for property records to show the actual legal status of each property at any given time, registration procedures must be clear and efficient. There must be public access to these legal records, the information and its significance must be transparent, and the records must be accurate, reliable, and up to date.

In Poland, registration procedures are provided in a number of laws, primarily the 1982 Law on Perpetual Books and Mortgages, the 1982 Law on Courts, and the 1991 Law on Notaries. Costs and delays resulting from these procedures represent a significant impediment to mortgage finance, as discussed in Section 4.4.3, below

4.2.3 Enforcement Laws

These are the laws under which the lender can enforce its rights in the event that the borrower defaults in obligations under the loan. A functioning mortgage finance system must be predicated on the assumption that a very large percentage of borrowers will repay their loans. Strong and efficient enforcement laws serve to deter loan default by affording the lender certain and reasonably expeditious access to collateral used to secure the loan and to other assets of the borrower, such as wages. If the borrower knows he must pay or the bank will have the power to take part of his wages or even take away his home, he will do everything possible to avoid a default.

Enforcement laws provide procedures to seize (acquire legal possession of) the borrower's assets, sell them, and distribute the proceeds to the borrower's creditors. Assets subject to seizure and sale under the enforcement laws include the real estate that was pledged to obtain the mortgage loan, the borrower's wage or pension income, the borrower's personal property, and the assets and property of persons who serve as guarantors for the loan. Enforcement laws also regulate the costs and expenses likely to be incurred in pursuing these remedies.

Enforcement laws establish the priority of liens if there is more than one; that is, they provide for the order of payment from the proceeds of assets that have been seized and sold. Priority is based on factors others than sequence of registration, so the registration records themselves are not sufficient to establish lien priority.

In Poland, the basic law on enforcement of mortgage obligations is provided in Section 1025 of the 1964 Code of Civil Procedure. There are several significant problems in this law. First, mortgage liens have a low priority in the order of payment from a debtor's assets. The most significant problem in the order of priority is that mortgages come after tax liens and other financial obligations of the debtor to the state, no matter when such obligations arise. Moreover, these state obligations need not be registered or otherwise disclosed to be effective. The possibility that substantial "hidden" liens on a property may arise and take priority over the mortgage makes it impossible for a lender accurately to assess risk to the security of a loan at the time the loan is made. This issue is discussed in Section 4.4.1, below. A second problem with Section 1025 is that enforcement procedures are costly and unnecessarily time consuming. This issue is discussed in Section 4.4.2, below.

In 1996, Poland adopted a Pledge Law which made one significant improvement in law on priority of payments resulting from enforcement procedures: it eliminated Section 1025(5) of the Code of Civil Procedure, which had required proportionate payment of debts owed to other banks as a priority over payment to the mortgage lender.[62]

4.2.4 Foreclosure and Eviction

Foreclosure occurs when the lender uses legal procedures to seize the real estate that was used to secure a mortgage loan (so-called because these procedures extinguish or foreclose the ownership rights of the borrower), followed by sale of the property by the lender to recover at least some of the losses resulting from the bad loan. An important corollary to the lender's right to foreclose is the right to evict the borrower, if the borrower does not vacate the property willingly. Otherwise, it would be difficult if not impossible for the lender to sell the property.

Prior to recent efforts to reform the legal framework for mortgage lending, foreclosure could not be accomplished without court procedures that could take several years to complete. The resulting expense and uncertainty made foreclosure an unattractive option to lenders. Even if the lender were willing to undergo the court procedures necessary for foreclosure, it had to initiate additional procedures (sometimes involving additional court hearings) to evict the borrower. Finally, the lender had to provide the evicted borrower with an alternative dwelling unit before the eviction could be carried out.

Poland has made two important changes in its legal framework to expedite foreclosure and eviction:

- elimination of the requirement for a judicial procedure for foreclosure, accomplished in the 1989 Banking Law, Section 52.2;[63] and

[62] The Pledge Law made this provision applicable to mortgages on immovable as well as movable property. Otherwise, the Pledge Law applies only to movable property.

[63] Nonjudicial foreclosure is possible if the borrower and lender so agree in the loan agreement, and if the loan documents are prepared in accordance with certain technical criteria.

- elimination of the requirement to provide substitute housing to an evicted borrower, as a result of the abrogation in 1995 of a 1966 Ministry of Justice (MOJ) regulation on eviction procedures.[64]

4.3 Where Does Poland Stand in Mortgage-Related Legal Reform?

The table below compares the status of some of the legal framework issues in Poland with Western Europe,[65] and with other countries in Central and Eastern Europe engaged in economic transition similar to that of Poland.

Table 4.1
COMPARISON OF HOUSING FINANCE LEGAL FRAMEWORK
WITH WESTERN EUROPE AND OTHER CEE COUNTRIES IN TRANSITION

	Western Europe	Hungary	Czech Republic	Slovakia	Poland
Efficient registration	Yes (generally)	Yes	Yes	Yes	**No**
Appropriate priority for mortgage	Yes	Yes	No	Yes	**No**
Expedited enforcement procedures	Mixed	Yes	Yes	Yes	**No**
Nonjudicial foreclosure	Yes (generally)	Yes	No	Yes	Yes
Right to evict borrower w/o substitute housing	Yes	Yes	Yes	Yes	Yes

64 The substitute housing requirement under the 1966 MOJ regulation applied to eviction from both rental housing and owner-occupied housing. In 1994, a new Law on Housing, Sections 36-38, made it possible to evict tenants without the obligation to provide substitute housing under most circumstances. Shortly after, the MOJ regulation requiring substitute housing was itself eliminated. While eviction "to the street" is still uncommon, a Warsaw judge reports that it has occurred in the past 2 years, and a court would have no choice but to order it if the facts of the case justified eviction.

65 A comparative survey of enforcement procedures in European Community countries found that procedures are not uniform, but share sufficient fundamental similarities to make cross-border transactions feasible. The EC recognizes that preserving fair competition among mortgage lenders may justify the lack of perfect uniformity in treatment of creditors from one EC country to another. "Comparative Study on Real Estate Enforcement Procedures in the EEC Countries," EC Mortgage Federation, Brussels, March 1993.

4.4 Significant Legal Impediments to the Development of Housing Finance in Poland

Despite the progress that Poland has made in creating a legal framework conducive to mortgage lending, there are three areas where Poland still has substantial problems to resolve: the lack of appropriate priority for the mortgage after foreclosure, especially as a result of having lower priority than tax liens, which need not be disclosed; the lack of efficiency in enforcement procedures; and the lack of efficiency in registration.

4.4.1 Statutory Tax Lien

According to Polish bankers and lawyers, the key legal impediment to development of market-based mortgage lending is the lien for tax and other financial obligations to the state. This so-called statutory lien is problematic for two reasons: it comes before the mortgage in distribution of proceeds from foreclosure and sale of the property, and the lien does not have to be registered or even disclosed to be effective. The nature of the lien and its priority position results from the interaction of several laws: the Code of Civil Procedure, Section 1025(3); the 1982 Law on Perpetual Books and Mortgages, Section 66; and the 1980 Law on Tax Obligations, Section 24.

If a borrower fails to pay his taxes or other financial obligations to the state after obtaining a mortgage, the state's statutory lien takes priority over the lender's lien if there is a foreclosure sale. As a result, banks cannot predict with any certainty that their right to payment is actually reasonably secured by the mortgaged property, and whether they can hope to get paid if the borrower defaults. While MOF and MOJ officials report that the state's statutory lien rights are infrequently invoked, the uncertainty itself creates higher risk for lenders and in some cases a reluctance to make mortgage loans at all.

The recommended intervention for this problem is to change the laws that provide priority for the undisclosed statutory lien. The 1980 Law on Tax Obligations is widely considered to be obsolete. A new Tax Code was drafted and submitted to Parliament by the MOF in 1995, but it is not actively under consideration at this time and there is little hope that it will be taken up before September 1997, when a new session of Parliament is convened.[66] The proposed Tax Code, which would supersede the Law on Tax Obligations, would require the establishment of a tax registry, and that a tax lien be registered within a specified time period for it to be effective.

It is also advisable to address the order of priority of payment with regard to tax liens. There are legitimate policy reasons for tax liens to take priority over mortgage liens, and the laws of many countries reflect this. Usually, however, there are qualifications or limitations on the effect of the lien. Most countries require that tax liens be registered, which puts a lender on notice that its security may be in jeopardy. Common practice in the United States is for mortgage documents to include "cross-default" provisions, so that failure to pay taxes constitutes a default in the mortgage terms. With notice of the filing of a tax lien, a lender can take early action against the borrower and minimize its losses. In another approach, a law recently adopted in Slovakia provides that a tax lien takes priority over a mortgage, but only for tax obligations unpaid for a maximum of three years. This is a matter of policy that must be resolved by the interested parties. In any case, it is essential that lenders have access to information about the status of the borrower's other debts, so that action can be taken if the lender's lien is threatened by other claims.

[66] When a new session begins, pending laws are no longer valid and must be re-submitted.

Efforts to promulgate a Tax Code in Poland, which were led by the Tax Reform Working Group of the Ministry of Finance, should be encouraged. There are also other indications of change in policy on the statutory tax lien. The new Pledge Law (adopted in September 1996, to take effect January 1, 1998) removes the statutory tax lien priority unless it is disclosed and registered prior to the pledge, but this only applies to enforcement of liens on movable property. In addition, the draft of the Mortgage Banking and Mortgage Bond Law in the MOF contemplates eliminating the priority of the tax lien unless it is disclosed, but in the draft this only applies to mortgage banks. From a policy standpoint, there is little reason for this limitation -- the security of assets of all banks should be of concern to the MOF. Some commentators on the draft law already have urged that the elimination of the priority of the undisclosed tax lien be extended to all banks making mortgage loans. A new draft of the Mortgage Banking and Mortgage Bond Law, prepared in late November 1996, does not adopt this suggestion, however, which indicates that the MOF is not amenable to yielding the privileged status of the tax lien in the case of all mortgage loans.

4.4.2 Costs and Delays of Enforcement Procedures

A second major impediment to housing finance is the cost and delays of procedures required to enforce a lender's rights when a mortgage is in default. The enforcement procedures derive from a labyrinth of laws and regulations -- the Code of Civil Procedure, the Law on Courts, regulations on enforcement officers, and others.

The solution is to amend the procedures in these laws, particularly with regard to two issues. First, most of the fees charged by the court for carrying out enforcement actions must be paid in advance. As a result, there is little incentive for speedy or even effective enforcement. Second, the enforcement activities are divided by court districts and enforcement subdistricts, with only one bailiff (enforcement officer) per jurisdiction. Most bailiffs are overworked, and the quality of their services varies, but lenders who must pay for their services have no choice in who will perform this work. These problems could be remedied by privatization of bailiffs (who would still work under court supervision), which would create competition and choice for lenders who use these services. Notaries were privatized in Poland in 1991; reportedly, this has led to greater speed and efficiency in notary procedures. Privatizing bailiffs could have the same effect on enforcement procedures. Privatization of bailiffs has recently been accomplished in Hungary, where this change is regarded as very successful.

A Commission on Civil Law Reform under the auspices of the Ministry of Justice, which was in effect from 1990-95, was reconvened in December 1996. The Commission will have jurisdiction to consider and recommend changes to the enforcement laws, and has already announced that this will be one of three major topics it will address over the next several years. For guidance from other countries in transition, where there were similar problems with enforcement, the Commission can look to market-oriented enforcement laws recently enacted in Hungary, Slovakia, and Croatia.

4.4.3 Costs and Delays of Registration

The third key legal impediment is problems with registration under the Law on Perpetual Books and Mortgages. Registration is very costly because notary fees and mortgage record entry fees are calculated as a percentage of the cost of the underlying transaction, that is, the amount of the loan. The delays come primarily from the system of using judges for certain purely administrative tasks, such as logging in the application for registration and calculating the fees, and well as for the more substantive responsibilities relating to reviewing the application file. If the judge discovers problems with the application, letter of inquiry and response may be exchanged by mail or hearings may be scheduled. Because of other demands on a judge's time, sometimes no action is taken for many months. Some lenders report that they will not disburse loan funds until registration is complete; those that do disburse pending the completion of registration recognize that they are incurring additional risk in doing so.

One suggestion to relieve the registration bottleneck has been to create a new position of referendary clerk, to whom can be delegated many of the administrative responsibilities of the registration process now handled by judges. This system is used in Germany. A proposed law recommending this action has been prepared by the Ministry of Justice and recently submitted to Parliament, so it is likely that there will be some change in registration procedures in the near future. In addition, administration of registration can be improved up by computerization and centralization of records. The CORS Project, with the support of the World Bank, is working on computerizing and modernizing the registration system, but completion of this work is not expected for at least five years.

4.5 Other Relevant Laws and Legal Issues

A number of other newly enacted laws and legislation currently under consideration could have an important impact on housing finance, including laws on Mortgage Banking and Mortgage Bonds, Contract Savings, and Housing Rehabilitation. Except for the statutory tax lien issue in the draft of the Mortgage Banking and Mortgage Bond Law, discussed in Section 4.4.1, above, these laws do not present issues relevant to the legal framework for housing finance; their significance from a policy or fiscal standpoint is discussed in other chapters of this report.

There are legal problems with respect to mortgage lending in laws relating to the multifamily housing sector which deserve mentioning. Under the Cooperative Law of 1982, as amended in 1994, lending for purchase or renovation of individual apartments is constrained by the lack of clarity in the legal status of cooperative rights as opposed to ownership. Lenders remain reluctant to make mortgage loans since they cannot be sure about the nature of the property that secures the loan and what their rights will be if they acquire cooperative property through foreclosure.[67] Since full membership rights are not conferred until construction is complete, financing an individual's share of the construction costs is particularly risky. Other countries in the region, such as Czech Republic, Slovakia, and Hungary, have resolved problems with cooperative ownership by enacting laws which confer full ownership rights on paid-up cooperative members, and compel the cooperative to comply with this change in ownership status. Another impediment to financing for construction is the high risk of unexpected increases in cost. The cooperative administration establishes the costs with little input from the members, so it is difficult to predict the costs with any level of precision when an

[67] The 1994 amendments to the Law on Cooperatives introduced less rigid rules with respect to use and disposal of membership rights. A number of significant impediments remain, however, such as the "rule of single-entry right," which limits cooperative rights relating to a single dwelling unit to only one person (natural or legal), and requires that an heir of cooperative rights take certain specified actions within a short period of time to effect the inherited rights.

individual applies for a loan to cover his share of the costs. Limits on liability under the Cooperative Law further constrain lending to the cooperative sector.

The Housing Unit Ownership Law of 1994 (the "Condominium Law") fails to grant full legal status to the condominium owners' association. According to Polish condominium experts, this was done to preserve joint and several liability of the individual owners for obligations relating to the condominium as a whole, apparently to protect contractors from association default. This issue generated controversy at the time the law was passed, and remains contentious today. It constrains lending for condominium purchase or renovation in several ways. First, the security of one condominium unit used to obtain a mortgage loan could be compromised by the debts of the association or even the other owners. Second, banks are reluctant to lend to the association because of its uncertain status. In order for a condominium to obtain financing for common area improvements, every owner would have to enter into a separate loan agreement with the lender, an unwieldy process, even assuming unanimity among owners could be achieved. Clarification of the legal rights and liabilities of the association is important to make easily available the financing needed to preserve and improve the existing multifamily housing stock.

A new draft law on the Use of Real Property, approved by the Council of Ministers in September 1996, will regulate several important issues if passed by Parliament, including the acquisition, sale, and use of land and other real property owned by the state or gminas. Disposal may be made through sale, perpetual usufruct (for example, by 99-year lease), or long-term management arrangement. The draft law also includes regulations for mapping, zoning, surveying, and appraising real estate, and restitution of property expropriated between 1945 and 1960.

4.6 Conclusions

Poland, like its neighbors, has made progress in establishing the legal structure necessary for housing finance. Nevertheless, several significant impediments remain. Demand for mortgage financing is expected to increase significantly in the coming years and, with the initiation of mortgage banking, mortgage bonds, and other secondary market initiatives, the housing finance system will become more complex. For Poland to have an efficient, market-based housing finance system capable of meeting a future increase in demand, it is important to remedy the remaining impediments now. Solutions to administrative problems relating to the efficiency and cost of enforcement and registration procedures are now under consideration by Parliament and by the Civil Law Commission under the auspices of the Ministry of Justice; adoption of these changes seems likely to occur. Implementation of the changes, however, will be a lengthy and difficult process, for which training and technical assistance could be very helpful.

The most important legal problem remains the "hidden" statutory tax lien. Policy-level discussions with the MOF of the tax lien's effect on the development of mortgage finance should be continued. These discussions could be facilitated by a study of the relative value to the state treasury of continuing the tax lien on the current basis, as opposed to the economic growth that could result from removing this impediment to housing finance.

5.0 PUBLIC SECTOR HOUSING FINANCE

Introduction. Poland is now in the process of developing a fundamentally new approach to public sector housing finance, subsidies, and incentives. A number of important reforms have been passed in the last several years; some of these are already being modified and additional policies are currently under consideration. The delivery of funds for public housing finance takes a number of forms -- subsidized loans, income support policies, tax policies, and technical assistance -- and funds are being put to numerous uses. Two summary characteristics of the new policies are of particular importance. First, Polish policymakers have recognized the need to simultaneously address new construction of affordable housing, rehabilitation of the existing stock, and development of housing-related infrastructure. Accordingly, an institutional structure is now being put in place in response to these needs. Secondly, they recognize that public funds can ultimately be only a small share of the overall funds required, and thus have aimed many of their policies at various forms of public/private cooperation.

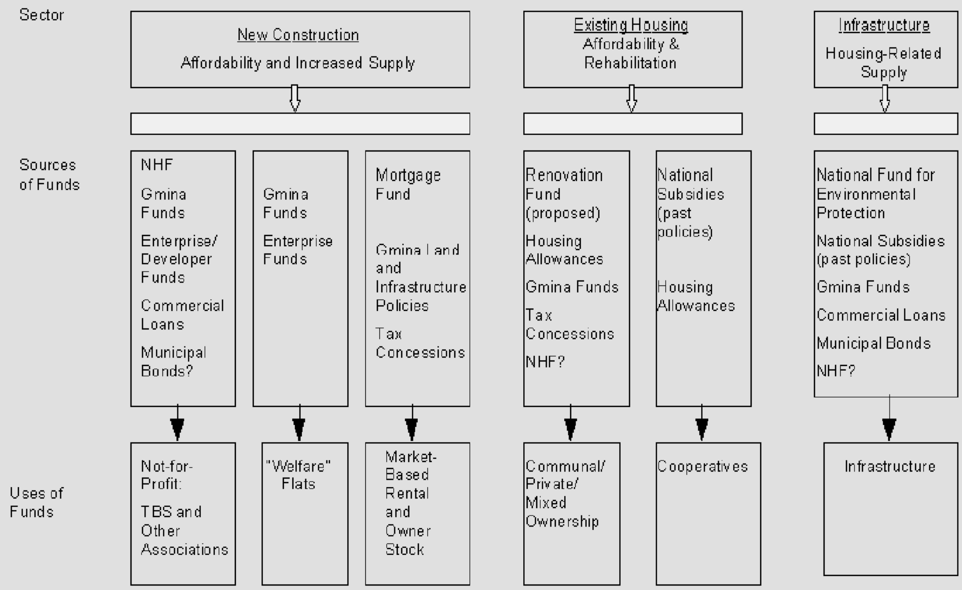
This chapter addresses the key programs in public sector housing finance directed at not-for-profit rental construction, rehabilitation, housing-related infrastructure, and income support through housing allowances. The chapter focuses on national policies, and also on the all-important role of the gminas in designing and implementing the housing and infrastructure programs. Figure 5.1 summarizes the sources and uses of public and private funds of primary importance to the discussion in this chapter. The general goals that were noted in Chapter 1.0 for public sector housing finance -- an increase in private funding, development through private/public partnerships, and enhanced gmina responsibilities as an “enablers” of housing development rather than as direct providers -- are inherent in the new policies. The **specific goals** of these policies include the following: (1) to stimulate the development of not-for-profit rental housing for modest income households; (2) to rehabilitate some portion of the public and private stock; (3) to assist in development of housing-related infrastructure; and (4) to enhance the affordability of communal, cooperative, and other housing stock for very low income households through housing allowances.

The primary **tools** are various subsidies, rent policies, and incentives to encourage the supply of affordable housing and provide incentives for private sector funds to increasingly support both housing and infrastructure. As noted in Figure 5.1, the initiatives include programs at the national level: the National Housing Fund, (which may finance not-for-profit housing, rehabilitation, and infrastructure); the proposed National Renovation Fund (rehabilitation, modernization); and the various national and voivod programs which assist infrastructure, including the Municipal Development Agency (MDA), and the Fund for Environmental Protection (NFOS), which assists with environmentally-sensitive infrastructure. In addition, gminas, in response to their major responsibilities under decentralization, are undertaking their own efforts to finance and/or encourage additional housing and infrastructure and manage the communal stock.

Based on our review of the various policies, it appears that many of the institutional components of a new housing system are in place or in planning, and many of the policy reforms have been initiated. As noted above, nearly all of these changes are recent; some have begun to be implemented (rent structure, housing allowances, condominium formation) and others have not as yet prompted the hoped-for response (TBS, not-for-profit rental housing). Others are just now emerging, such as municipal bond financing for infrastructure and/or housing. Finally, others are still on the drawing board, such as the Renovation Fund.

Figure 5.1

Poland's Public Housing Finance System



As will be discussed in the sections which follow, Polish policymakers should continue their ongoing assessment of the new programs and of the household and income groups that they serve. This should serve the following purposes:

- Based on various critiques of the parameters of several of the programs, **several newly formulated programs** may need some adjustment in order to better accomplish their goals. This includes the NHF/TBS parameters, rent policy, and housing allowance policy. A number of suggestions are made in the following sections of this chapter.

- More emphasis should be placed in the future on **strategic planning** and policies that would allow the public sector **-- based on feedback concerning effective demand determined at the local level --** to set funding priorities among the agendas for the existing stock and new construction.

- Similarly, gminas should be assisted in strategic planning, to help them take an **increasingly "enabling" role in the housing sector** via increased privatization, public/private partnerships, and assistance to condominium associations, rather than direct ownership and management of the housing stock. Privatization of the housing stock has been relatively limited in Poland; thus, the public rental sector remains large by international standards. In addition, as discussed below, unless rents in communal housing are increased, incentives to develop either market rate rental housing or TBS/not-for-profit housing will be dampened.

- Finally, policymakers should assess how future policies **can link public housing finance efforts more closely with policies in private sector housing finance and capital market**

funding. Examples include liberalization of NHF/TBS parameters to provide increased incentives for public/private partnerships; assistance in affordable home ownership for targeted households (through grants and/or loan guarantees); additional assessment of the use of grants rather than subsidized loans (which can interfere with Poland's efforts to establish market-priced funds); and development of models whereby NHF can raise long-term funding on the capital market.

Section 5.1 provides an overview of funds in Poland's public housing finance programs. Section 5.2 discusses the NHF and TBS/not-for-profit initiatives, while Section 5.3 notes key issues surrounding rehabilitation and infrastructure policies. Section 5.4 discusses additional aspects of gmina responsibilities, including policies for rent, housing allowances, and privatization. Section 5.5 offers some conclusions and a "vision" of the structure of public sector housing finance in the year 2000.

5.1 Funding Public Sector Housing Finance

As a result of the housing and infrastructure subsidy policies in place over the past decades and the recent slowdown in housing construction, Poland faces the dilemma of needing to address multiple concerns simultaneously with very limited budgetary resources. In addition, Poland's public policy is further constrained by two factors: the burden of making good on past subsidy policies and the clear need to maintain fiscal austerity in the fight against inflation. As was discussed in Chapter 2.0, Poland's housing supply was not seriously deficient at the beginning of the reform period, in comparison with other transition countries and countries with similar levels of income. However, the recent slowdown in construction and the lack of funds for rehabilitation have now led to a greater sense of urgency. As noted, new completions totaled only about 55,000 units in 1996. Also, the Act on Renovation is predicated on estimates that indicate that many flats need rehabilitation or demolition: 1,390,000 in total. Although these estimates may be overstated, as discussed below, it is nevertheless crucial to bring all the available public housing finance assistance into active play as soon as possible.

Table 5.1 summarizes recent budget figures for existing programs. In both 1996 and 1997, over 85 percent of national budget funds are earmarked to fund the past subsidy policies: a legacy of the previous system. Thus, the National Housing Fund, for example, has only PLN 120 million to assist both affordable housing and renovation. Although providing another PLN 160 million is apparently under discussion, this is still a modest sum. The proposed funding for the Renovation Fund is also modest, especially in the early years.

Is There a Finance Gap in Housing? This question is extremely difficult to answer because of the inherent difficulty in establishing a credible or realistic estimate of need, either for new construction or rehabilitation. Establishing relative priorities among new and existing stock and infrastructure is even more problematic. The priorities among these activities are largely set at the local level. This is as it should be; depending on the local and regional growth scenarios and the characteristics of the standing stock, the gminas differ greatly in their relative needs for not-for-profit rental housing, rehabilitation, and infrastructure, as well as other land or infrastructure policies aimed at market-based housing. However, national policymakers, simply by establishing national funding mechanisms with particular levels of funding and particular subsidy policies, also influence these choices. Thus, as we recommend in the closing section, policymakers must pay close attention to gmina demands. Poland's policymakers will continue to be severely constrained until substantial progress has been made in paying off past subsidies.

TABLE 5.1
HOUSING SUBSIDIES IN THE NATIONAL BUDGET
(millions of PLN)

Type of Program	Purposes	1996 Budget	1997 Budget	Comment
National Housing Fund	Not-for-profit Rental Housing, Infrastructure, Rehabilitation	PLN 120	PLN 120	Discussions under way at BGK regarding adding PLN 160
National Renovation Fund	Rehabilitation, Modernization, Restoration, Revitalization	N.A.	N.A.	Draft Legislation includes plans for National Subsidies of PLN 37 in Year 1 to PLN 185 in Year 10
Housing Allowances	Affordability of Communal, Cooperative, and other/private housing	PLN 460	PLN 430	The Housing Allowance program has been utilized at a lesser rate than expected.
Sum of Past National Subsidy Policies	Includes interest payments and past subsidies to Gminas and Cooperatives for housing and infrastructure	PLN 3430	PLN 3478	Represents 85.5% of the total budget in 1996 and 86.3% in 1997

Public Finance Goals. To simply call for additional public funds to be devoted to housing construction and renovation to address the housing shortage must be considered in context. Clearly, more funds could probably be effectively utilized, especially in the medium term. However, as discussed below, additional funds should not be delivered at an overall budgetary level that would weaken the fight against inflation, which is probably the single most important deterrent to development of the housing sector. Thus, the real challenge lies, in part, in achieving other goals in public sector finance policies: **(1) efficiency and targeting of subsidies; (2) strategic planning for both gminas and national institutions; (3) leveraging of private capital; and (4) transparency and public education about rights and responsibilities under the new policies.**

5.2 The National Housing Fund and the TBS: Goals and Prospects

Creating a New Rental Sector: The TBS. The public rental housing sector in Poland is currently characterized by low rates of investment, low rents, and concentrations of poorly maintained units. The reported shortage of a million rental units, as estimated by the Housing Institute, not only results in crowding, but acts as a brake on labor mobility as the Polish economy grows and changes.
In 1995 the Government of Poland, in the recognition that owner occupation options were not easily affordable for many households, particularly urban households, introduced legislation to create an affordable rental housing sector. The broad aim was to develop a Western European-style sector of not-for-profit organization, the TBS, to be supported through the National Housing Fund (NHF). The NHF, located within the Bank Gospodastwa Krajowego (BGK), has as multiple goals: not only to provide subsidized loans for new construction, renovation, and housing-related infrastructure, but also to support and supervise the contract savings scheme for housing purchase.

The legislation and ordinances pertaining to the NHF and the TBS permit a wide range of activities and potential housing policy roles. The government placed an initial emphasis on the promotion of rental housing investment for moderate income renters, with income eligibility limits for the scheme placing potential tenants above the housing allowance limit.[68] The essential rationale for this approach is that production would be possible with limited rates of loan subsidy, and that lower income households would benefit as TBS residents "filtered up" from other rented housing.

The TBS, or other forms of not-for-profit organization, have great potential significance over the long term to create a more diverse competitive and flexible rental housing system. Legislation envisaged that the TBS could compete to provide management services for gmina housing stock, become recipients of stock transferred from gminas and other enterprises, and develop projects which are able to utilize private finance to support not-for-profit provision. In Western Europe over the last decade, housing policies have emphasized the enabling role of local authorities and developed the roles of not-for-profits in rental housing provision, generally in public-private partnerships involved in renovation as well as new construction. Thus, the TBS offers the prospect not just of more housing units but of changing the performance and culture of the housing system.

The sections which follow place great emphasis on these possibilities. The recency of the legislation does, however, mean that there is little current experience to draw upon.

5.2.1 The National Housing Fund

Depending on whether a short-term or long-term perspective is taken, there are two ways of looking at the NHF. If the TBS is regarded simply as a new route for government subsidy for rental housing, then the Fund can be seen as a subsidy allocation/supervision device lying between the Ministry of Finance and the subsidy end-users, the TBS. **The alternative view, which has to prevail if the TBS sector is to be connected to the emerging market in Polish housing finance, is that ultimately the connections between the NHF and domestic and international funds markets are critically important.**

[68] The TBS/not-for-profit projects are appropriate for those in the third and fourth quintiles of the income distribution, roughly, households in the 40th to 80th percentiles.

Discussion of the NHF and the TBS has tended to focus upon the public finance allocation/ scrutiny issues. This is unsurprising, as the system is in its infancy and at present the NHF is entirely capitalized by public funding. Much has been achieved in establishing the NHF over the last two years, but there has on balance been relatively little reflection on the roles and financing of the NHF and the TBS five years ahead. Such consideration is essential if the structures and mechanisms of the NHF are to attract private loans. In the following paragraphs, developments to date are assessed in this broader context; considerations which still may need to be addressed are emphasized.

The planned-for core business of the NHF is to provide subsidized loans to the TBS for new construction, renovation, and infrastructure. Subsidized loans will comprise a maximum of 50 percent of costs for projects which meet cost guidelines and building standards and which are rented to the target income group at rents not exceeding 4 percent of replacement costs (determined by the voivods). Tenants will provide 10 percent of project funding, and this share will be refunded (indexed to replacement costs) should the tenant move. The remaining 40 percent will be provided, in cash or kind (e.g., land and infrastructure), by TBS partners. TBS investor partners are likely to be gminas but can include co-operatives, enterprises, and others.

In principle, the 40 percent share from partners could include commercial loans as well as equity. However, financial simulations at NHF assume that the likely lending instrument will be an NHF 30-year loan, with a two-year grace period, and that repaying this loan will exhaust rental revenues, net of management and maintenance costs. **Thus, under this scenario, unless rents were to be higher or interest subsidies on NHF loans increased, there is no capacity for the TBS to raise loan financing at market rates.** This is likely to leave the new system dependent upon the volume of NHF funding derived from government on the one hand, and on the other, the willingness of partners to donate substantial tranches of equity. Simulations run at NHF indicate that interest-rate subsidies will provide a 60 to 70 percent subsidy on the NHF loan, or 30 to 35 percent of overall project costs. With donated equity at 40 percent, the overall subsidy to project tenants will then approximate 70 to 75 percent of costs. The different long-term consequences of alternative financing models, such as grants rather than loans, have not apparently been assessed.

There are two routes away from such dependence on state funding of the NHF. The first, noted above, is to allow the TBS higher net rental income streams. The second, which is intended by the NHF, is to use private finance raised by NHF bond issues to replace the loan (but not the interest subsidy) funding from the Ministry of Finance. Indeed, these important policies may be used in tandem, and may ***need*** to be used in tandem to support viable projects in the long term. It is important to consider how progress to date in NHF structure, supervision, and strategy facilitates these private financing possibilities, as well as the efficient allocation of government funds to the TBS.

Fund Location and Government Support. The NHF comprises two components, funding for the TBS, and as discussed in Chapter 3.0, the contract savings scheme. The BGK, the locus of the NHF, pursues a range of activities in addition to the NHF. The question arises as to whether these co-location arrangements are necessary or efficient, especially in the longer term.

A previous assessment of these arrangements concluded that the separate activities within BGK and the NHF, were transparent. The Ministry of Finance, in its annual allocation of funds to the NHF clearly separates support levels for the two schemes. Within the Fund, accounting arrangements also ring-fence the two activities, and they in turn are transparently separated from other BGK activities.[69]

In the short term, co-location may offer some modest spreading of overhead costs, but this will decrease in significance as the fund expands. It is also arguable that in the current Polish context, where housing finance

[69] These arrangements, while giving comfort on transparency and accountability, also paradoxically suggest that there is no fundamental reason for the activities to be co-located. Refer also to the discussion of contract savings in Section 3.5.

skills are in short supply, the location of NHF within the BGK has helpfully provided access to a banking "culture" and skills. Again, however, as the Fund develops momentum and its own expertise, these advantages will be less relevant. In the long term, the contract savings scheme could be more effectively located with other mortgage market activities. And as private finance becomes a key component of the NHF, private investors may require reassurance that the Fund is truly insulated from the BGK in relation to information opportunities.

Government Funding for the NHF is provided on an annual basis from the Ministry of Finance, with a broad breakdown of activities to be supported in the year ahead. So far, with the system in its infancy, and loans issued running at a low level in relation to loan funds, this arrangement has posed few problems. But there is a big difference between funding an experimental stage and a full-scale program.

When NHF loan programs expand, there will have to be a qualitative change in the link between the NHF and the Ministry of Finance, if public money is to be used effectively. First, NHF will require more than single-year funding if it is to plan properly. Indications of likely levels of support over a 2- to 3-year period would be helpful. Second, the NHF should analyze the expected pattern of TBS support, broken down by new construction, renovation, and geographic regions. If no such development program is prepared, then there is no guarantee that NHF spending will be responsive to Poland's regional and local housing policy objectives. In short, this requires the Office of Housing to have a national housing strategy and the NHF to have a strategic business development plan. Within that process will also have to be an understanding of how NHF activities relate to the Renovation Fund and rehabilitation activities. Improved strategic clarity should facilitate increased interest of private investors in the NHF. Investors will rightly be concerned with the scale and structure of the NHF's program before they will be committed to more detailed scrutiny and funding of loans to the NHF.

Lending and Supervision. During 1996 the NHF has successfully devoted considerable effort to devising systems for scrutinizing loans and subsequently supervising them. Private investors in NHF bonds will also have to be convinced that these systems are adequate and that rental income will repay loans.

Both NHF and private investors will naturally also be concerned with the quality of the TBS organizations seeking loans. TBS business plans will have to be of a high quality, as these new organizations have no track record. Two approaches to monitoring and supervision are possible in the longer term. The simplest approach is for the NHF to assess loan applications intensively, being guided increasingly by past performance of existing TBSs. A second approach is to monitor existing TBSs more intensively, particularly supplementing TBS accounts with proxy measures of management performance. In this regard, NHF requires further development of its intended approach, and it has recognized this necessity.

Private Finance for NHF. It was noted above that the prospects for connecting the TBS to the private housing finance system would be facilitated by NHF transparency, a clear development plan for the TBS sector, and appropriate monitoring and supervision arrangements. Other changes or developments would facilitate this process.

If an increased role for private finance is to be limited to replacing the loan component within NHF spending, then a number of other considerations are pertinent. First, the NHF will have to devise and cost a strategy for engaging the interest of potential domestic and international sources of finance (the social housing loans market in Western Europe, unlike owner occupier mortgage markets, is truly international).

Secondly, NHF will have to convince bond investors (in the absence of costly government guarantees) that income streams are low risk and that the NHF has a clear claim on the assets financed by loans. Legislation has ensured the latter. The extension of the housing allowance scheme to TBS tenants, should they lose income, could also provide comfort in relation to income streams. However the still high rate of rent arrears tolerated in communal housing, unless TBSs are seen to be much "tougher" landlords, may discourage investors.

A third consideration, even when lenders' fears and unfamiliarity are overcome, is that new markets in social housing finance in Western Europe have typically encountered a 3- to 5-year period when lenders required a substantial interest premium over base rates, and over other residential mortgages. Until the NHF bond market is well and successfully established, private finance borrowing rates may be higher than now anticipated in NHF simulations. **Thus, the NHF must deal more directly with potential investors, concerns about asset security, rental stream risks, and the quality of TBS management. Only a protracted spell of successful operation will finally reduce perceived risks.**

Private Finance for the TBS. The more extensive engagement of private finance for Polish housing, beyond private sourcing of the NHF loan component, requires more radical departures from existing plans, particularly those limiting rents to 4 percent of replacement costs. At average cost levels (for a flat of 60 square meters) and with existing income limits for TBS eligibility, the rent-to-income ratio is likely to range from 15 to 20 percent. At this level, especially as rent payments include utilities, the ratio is not high by Western European or United States standards. **A rate of 6 percent of replacement costs, implying a 25 to 30 percent burden on incomes (not uncommon for above middle income renters in Western Europe and the USA and actually below average for low income U.S. renters), would provide significant scope for reducing subsidies and increasing private finance.**

The key constraint on such action is the low rent-to-income ratio in the gmina sector, since consumers will compare rent levels offered by the TBS unfavorably with rent levels offered by gminas. If there is no increase in gmina rents, demand for TBS tenancies, at even higher rental levels, may be constrained. And it is not just in this sense that the potential role for TBS is constrained by pricing of the gmina stock. If gmina rents were to rise to more than cover management, maintenance, and utility charges then the net rental stream would provide a basis for privately funded stock transfers to the TBS, and in many instances, net capital receipts to the gminas. Gmina rent increases may, however, be hampered by restriction of housing allowances to the poorest 20 percent of the population (see the discussion of housing allowances in Section 5.4 below). If rents in gminas and TBS do not rise, then the potential role of the TBS will be as a small niche player; there will be limited inflows of private finance, and no major restructuring of the rental system.

If the TBS sector expands and embraces a variety of roles, then the NHF may also have to differentiate its subsidy strategy. Renovation and new construction, for example, may require different subsidy policies and a different program structure. And if in the long term, the TBS does expand to embrace lower income households, similar rethinking may be required.

In summary, over the last two years Poland has taken major steps to revamp its approach to increasing the supply of affordable housing. The NHF has made much progress in establishing procedures to link existing levels of public funding to TBS loans. But looking forward, it is essential to develop within the NHF a strategic plan for new construction and rehabilitation, and more human resource capacity in housing finance which will meet the intentions of creating a more diverse, competitive, and privately-financed not-for-profit sector.[70]

[70] The British Know-How Fund is providing a long-term strategic advisor within the NHF, and short-term technical assistance and training. USAID maintains close contact with British Know-How with regard to the NHF and the TBS, especially because, as noted below, USAID is funding support to TBS development at local levels through a variety of channels.

5.2.2 The TBS

Although the NHF can provide subsidized loan finance to coops providing rental housing, it has been anticipated that the newly emerging TBSs are likely to be the main recipients of NHF loans. A TBS, established under the framework of corporate rather than cooperative law, has to have a Charter. It is recognized as a not-for-profit company in that the surpluses from its activities (specified in the Charter and restricted to housing and infrastructure activities, but not simply rental housing provision) are used to support housing investment and are untaxed. The shareholders of the company, who receive no cash return on their equity, appoint a Supervisory Board to oversee the running of the TBS by its staff. The likely shareholders in the present context are gminas, with other entities, such as co-operatives or firms, playing minor roles. In this important sense, the development of a TBS sector depends critically upon the support of gminas. Where gminas do not wish TBSs to form, then under present arrangements they can preclude a competitor/alternative from emerging.

By the end of September 1996, about six months into the program, some 59 gminas had indicated an interest in developing TBSs; two TBSs had received loans and a further five applications to the NHF were being processed. This level of interest in TBSs is less than had been anticipated, and although these are early days, it is hardly suggestive of a bottom-up response which will change Poland's rental-housing system. Some of the factors inhibiting progress, such as rent differences between gminas and TBSs, have already been noted in relation to NHF issues. The paragraphs which follow will focus on the policy parameters and operational issues which inhibit TBS formation now, and which may restrict evolution of the sector in the longer term.

Current Constraints. Although the legislation enabling the formation of TBSs was clear and concise, ordinances pertaining to client groups, permitted activities, and allowable costs have been detailed and changed over the last twelve months. The spread of substantive knowledge about the TBS and NHF lending instruments and processes across Polish gminas is still far from complete. The NHF, unless loan funds are to lie unused, may have to develop a more proactive strategy to promote knowledge of and interest in the TBS model.[71]

The extensive parameters and provisions of policy for the TBS leave them little room for maneuver. The client group, as noted above, is defined by legislation and does not constitute a group most likely to be the first concern of a gmina. Rent levels are set, in effect, by legislation and are likely to be triple the gmina average, emphasizing the low level of the latter. Allowable costs in construction (for NHF loan purposes) are determined by the construction cost index of the relevant voivod. An unrealistic view of costs, forced upon TBSs by the imposition of the index, is likely to cause the TBS major problems in securing loan financing as well as in the construction and operational phases of a project. NHF has recognized this difficulty and is now reviewing the construction cost index.

The most important constraint on current progress, conditioned by the difficulties noted above, is the difficulty in finding equity shareholders or groups of shareholders willing to fund 40 percent of development costs. TBSs have no surpluses of their own to invest, as they are only beginning to form; and in the longer term they are likely to earn only minimal surpluses from rent revenues (as explained in the previous section) under present rent/loan arrangements. It is worrisome that a substantial proportion of currently proposed "gmina" equity support is land and already-developed infrastructure, which had been assembled some years ago. Does this mean that gmina interest in "funding" TBS will diminish as stocks of "in-kind" resources are used up? There can be little doubt that gmina interest in the TBS would be greater if the required "equity" input were lower and the client group less affluent.

[71] USAID is providing business, strategic, and financial planning to TBSs and gminas interested in TBSs through several channels for technical assistance and training.

Even where gminas and others agree to form a TBS, the start-up difficulties are considerable. Forming a TBS, especially where there is political opposition to the notion of diverse rental provision, is a difficult and time-consuming business. Inexperienced staff with little resource support and no wider Polish experience of a "non-profit" formation to draw upon cannot be expected to push forward the TBS at a rapid pace. Some consideration could be given to the introduction of a "start-up" grant, from the central government, to facilitate TBS formation and cover staffing, office, and publicity costs. Extensive and early training is required for TBS staff and board members.

Once formed, a TBS has to develop a coherent business plan. This has been recognized by the government, the NHF, and those TBSs already in development. Business Plans will crystallize the issues facing the TBS and, as noted above, should pinpoint the areas where operational policies and staff skills are required. These include:

- coping with complex planning and building regulations in shaping developments;
- negotiating with equity partners and the NHF;
- setting rents and screening tenants; and
- providing management and maintenance services.

Looking forward, TBS staff, if the movement is to expand, will have to augment such traditional housing management skills with significant local entrepreneurial capabilities. For example, gminas may have to be persuaded to transfer stock for management to release the TBS from the potentially severe diseconomies of operating at a very small scale. Transfer of housing stock ownership would be another alternative. In a similar vein, TBS entrants now pay a 10 percent equity deposit. Over time could this be developed into a more permanent equity sharing scheme with renters purchasing larger tranches of equity as their incomes grow (with NHF subsidy repaid on such tranches). Another possibility is that the TBSs secure scale economies in construction by being encouraged to build and manage mixed tenure developments (but with subsidy only for rental units).

In Western Europe, not-for-profits, such as the TBS, have assumed significant roles in housing policy. They are well established organizations and have developed a distinctive range of roles. They often promote mixed tenures; this is possible in TBS legislation. They deal with low- as well as middle-income groups, unlike the TBS. They have put great emphasis on citizen participation; this issue has received little attention in the Polish context. They have significant and growing use of private finance with net rental surpluses requiring in-house financial and treasury management skills; the proposed Polish system does little to encourage local financial expertise with financial innovation left to the NHF. They have been at the core of local regeneration partnerships; in Poland, the role of the TBS both in renovation and the formation and financing of local partnerships remains unclear.

There is little doubt that, since 1994, there have been major successes in creating a framework for the NHF and the TBS. **The priority now is to link both the NHF and local TBSs to market possibilities in financing housing; otherwise they will play a lesser role than desired in creating a dynamic, competitive sector.** At both levels, NHF and TBS, there has to be renewed emphasis on strategic business planning and comprehensive development of finance and management skills.

5.3 Public and Private Financing for Rehabilitation and Infrastructure

5.3.1 Rehabilitation and the Proposed Renovation Fund

Introduction: The Complex Problem of Renovation. Rehabilitation of a significant portion of the housing stock in Poland is a key policy concern. The Housing Institute has estimated that some 820,000 units need to be demolished immediately and a further 570,000 units need to be rehabilitated immediately to avoid demolition. These 1,390,000 units are the subject of the proposed Act "On the Renovation and Modernization of Urban Buildings." As its justification, the Act notes two fundamental principles:

- the high degree of depreciation of parts of the urban housing stock;
- the "special nature" of restoration of old buildings: they can no longer be renovated through "simple undertakings by individuals."

The number of housing units and buildings that need renovation is only part of the problem, however. Neighborhood deterioration and run-down inner cities, in conjunction with older buildings needing both rehabilitation and improved energy conservation, make these "urban renewal" tasks extremely complicated. Mixed ownership patterns also add to the planning, financing, and coordination problems. In the United States and Western Europe there are now several decades of experience in area-based renovation projects. Areas, often with mixed housing tenures and mixed land uses, are now subject to approaches which emphasize the following types of issues:

- strategic neighborhood renovation partnerships, involving the community, the voluntary sector, the private sector, and the government;
- resident participation and mixed tenure approaches to housing; and

- integrated delivery approaches, with housing partners working together with environmental, social, and economic partners.

Poland is now developing an institutional structure to address renovation. The Renovation Act was drafted in 1996, and the issues raised in the proposed Act are still being debated and analyzed. The National Housing Fund, through organizations such as the TBS, is also charged with assisting with rehabilitation. And finally, the banks can offer rehabilitation loans, although this practice has apparently been very limited to date (the Mortgage Fund, in theory, could refinance rehabilitation loans). Since rehabilitation loans are typically smaller than mortgage credits for new construction or purchase, it seems likely that a wide range of owners could show considerable interest in such loans in the future.

Much of the responsibility for developing rehabilitation policies will fall, directly or indirectly, to the gminas. With a new national-level institutional/funding structure for rehabilitation now about to emerge in Poland, it is timely for gminas to initiate their plans. Gminas may wish to assist TBSs or specially-formed public/private partnerships to undertake this function. Similarly, at the national level, the institutional roles and rehabilitation goals of the NHF and the proposed Renovation Fund should be coordinated, both to avoid overlap and to develop clear goals and policies to which the gminas can respond. Thus, the following tasks should be addressed in a timely manner:

- the Renovation Act should be finalized as soon as possible and both the national agencies charged with renovation -- the Renovation Fund and the NHF -- should prepare appropriate statements of intent and assist in forming local funding/planning partnerships; and

- the gminas should develop their roles as strategic “enablers” and assist in creating local rehabilitation organizations for rehabilitation, and mechanisms for community involvement.

5.3.1.1 The Renovation Act

The Renovation Act, now in “second” draft form, presents a salient discussion of the very complex social and economic correlates of the depreciation of housing, including the degradation of adjoining neighborhood areas, public spaces, and technical infrastructure. It also discusses the fact that many buildings in a given area require rehabilitation, the fact that much of the dilapidated stock is private or of mixed ownership, and the fact that in many of the target buildings, households are likely to be poor, elderly, and overcrowded. The draft Act has been reviewed and commented on by gminas, owner groups, communities, housing associations, and others for a number of months. The revised draft (June 1996) did delete reference to obligatory renovation associations, which were widely held to be too complex, but other recommendations were apparently not taken into account.

The Act establishes a National Renovation Fund to “financially stimulate the process of renovation and modernization of housing stocks.” It is our understanding that both public and private properties can benefit.[72] Two funding variants are proposed:

- **Variant I: long-term subsidized loans** to owners covering up to 70 percent of the total cost of a renovation project, with a premium of 25 percent of the loan if the project is carried out as part of a program of renovation operations; and

[72] In fact, one potential criterion for selecting renovation sites would be willingness of private owners to participate, presumably with financing as well as planning assistance and cooperation.

- **Variant II: grant funding**, covering 20 to 50 percent of the standard costs of renovation and modernization buildings. The grants would be provided to property owners renovating apartment buildings or apartments as part of a program of renovation.

The Fund would receive both state subsidies and gmina funds based on a property tax on the usable square meters in each building. Simulations of likely outcomes and funding under each variant have been carried out and are included in the draft Act. Thus, under Variant I State funds would range from PLN 37 million in year one to PLN 185 million in year ten; when funds from loan repayments are also considered as well as gmina funds matching those from the state, total monies in the Fund would equal PLN 74 million in year one and rise to PLN 570 million by year ten. During the entire ten-year period, it is estimated that 176,800 units would be rehabilitated. Under Variant II, the grants approach, total available funds begin at the same level, PLN 74 million, but climb more slowly (in the absence of paybacks), and reach only PLN 370 million by year 10. This variant is expected to reach a greater number of units, however: a total of 240,000 units would be renovated over the ten-year period.

In analyzing the renovation proposals, several issues should be addressed:

- What is the probable magnitude of the serious renovation requirements?

- Are the funds sufficient, particularly in the early years, to address the "crisis" portion of the dilapidated stock? Sufficient in the long-term? How would the cost-sharing nature of the proposed funding impact poorer gminas?

- What types of design and programmatic issues are still outstanding, especially based on the results of the Lublin conference of July, 1996 and subsequent round table discussions?

5.3.1.2 The Need for Rehabilitation

Attempting to quantify the renovation problem is not simple. Some observers question whether the estimate cited above -- 1,390,000 units requiring demolition and/or rehabilitation -- is appropriate to Poland at this time, the problem being that the standard used is a Western one. If existing housing, for example, is subjected to measurement via a certain standard, the outcome is wholly dependent on the choice of standard and the standard may or may not be relevant to Poland's circumstances or the level of effective demand. Furthermore, how "need" and "ability to pay" coincide must then be addressed in order to formulate a well-targeted subsidy system. The simulation undertaken to help quantify the goals of the Act resulted in considerably fewer units being renovated than the estimate of need, roughly 176,000 to 240,000 units over ten years rather than the much larger number of units presumably in "immediate" need.

The relevant estimate of need -- the number of units that can benefit from rehabilitation (where the cost of rehabilitation is determined to be less than the value of the extended useful life of the stock) and where public funds are required to provide an affordable solution -- will probably not be determined until rehabilitation policies are more firmly in place and gminas make an assessment of the subsidy terms and other funds available to them relative to the worth of the affected stock. Thus, as we have argued for new construction of not-for-profit housing (and will do so below for infrastructure), determination of need is ultimately best assessed by the gminas themselves. Gminas will calculate the tradeoffs among, for example, participating in new construction, rehabilitation, infrastructure development, or any of the other responsibilities they face.

In fact, determining the need for rehabilitation may be even more difficult than that for not-for-profit housing because of the complex issues of urban renewal, the hoped-for urban spatial structure in the future, and the immediate practicalities of zoning. Decisions regarding neighborhood rejuvenation and the long-term appropriateness of the location of the dilapidated stock must be made. Thus, for a gmina, these urban planning issues result in numerous "externalities" which make the discounted present value of the stock in question very difficult to quantify. These factors suggest that the original estimate of need, which focused on "housing standards" but not the difficulties associated with gmina spatial dynamics and urban renewal, should not be used as the sole justification.

5.3.1.3 The Adequacy and Timing of the Funding

Given these types of complexities in determining need, it is suggested that the GOP remain highly flexible in determining the needed level of subsidy funds. However, whatever level of funding is ultimately determined to be relevant to gmina need, two additional matters may need to be addressed: timing and gmina financial circumstances.

First, the development of effective neighborhood rejuvenation and urban renewal projects has proved very time-consuming worldwide. Are there "crisis" dilapidation situations that need to be dealt with quickly? The original estimates suggested that 570,000 units need "immediate" rehab to avoid demolition. (It is not known how many of these need a subsidy to effect renovation.) However, under Variant I, only about 38,000 units could be assisted in the first four years, for example; for Variant II, this figure rises to 60,000. **This issue warrants further attention.**

Second, it is to be expected that a correlation will exist among the relative economic strength of gminas and extent of neighborhood and housing stock decline, and the income level of gmina inhabitants. Can poorer gminas afford the same contribution from real estate taxes as other gminas? Have transparent criteria been determined for determining what types of proposals would receive first priority? Which projects within gminas?

5.3.1.4 Outstanding Program Design Issues

Based on the results of the Lublin Conference[73] and discussions with experts concerned with rehabilitation, a number of design issues have been put forth as needing further consideration. These include the following:

- **More Flexibility in Funding Mechanisms.** It is felt that the mechanisms for funding rehabilitation should be more diverse and include both grants and loans. Experience from Western Europe suggests that they should also be linked to tax credits, as discussed below.

[73] Seminar on City Revitalization, "Seminar Conclusions," Lublin, July 1 and 2, 1996; sponsored by the City of Lublin and the Gmina Housing Partnership and funded by USAID.

- **Better Incentives for Private Financial Participation.** The Lublin Seminar showed the necessity for developing financing scenarios better directed at private investors, which might include homeowners, tenants, private landlords, and investors. Tax credits may be an important fiscal incentive. Since credits available for rehab are currently much smaller than those for new construction, it may be salient to ask whether the tax credit policy should be reformulated. Public/private partnerships have proved an important tool in major regeneration projects.

- **The Renovation Association.** Some agreement has apparently been reached that the mandatory renovation associations initially proposed were too complex. The Lublin seminar suggested an organization external to the gmina which would serve as a coordinating body. However, it is also not clear how this organization would function nor how it would be funded. How, for example, could gminas get project design help if they required it? In complex situations, renovation/urban renewal requires urban planners, infrastructure planners, budget experts, rehabilitation engineers, and so forth.

- **Regulations on Restoration of Historic Buildings.** It has been suggested that the rules guiding restoration of historical buildings are too rigid and could slow down progress on initiating renovation activities.

- **Simplification of the Act.** Finally, the Lublin seminar suggested that the Act should be simplified overall, and refrain from specifying the details of implementation of renovation projects. This is felt to be the role of the community.

- **Development of Alternative Instruments: Rehabilitation Loans from Banks.** Individual household rehabilitation loans from banks are expected to become a more important aspect of private mortgage finance than at present. A related issue involves loans for large scale renovation, which could involve a renovation group or gmina borrowing to rehabilitate one or more buildings, possibly in combination with household borrowing.

Institutional Roles and Rehabilitation Funding. In summary, we suggest that both the NHF and the Renovation Fund should clarify their respective roles regarding renovation and thus provide the gminas with opportunity to develop their funding strategies. Also, assuming that the Renovation Fund will be assisting complex neighborhood revitalization projects (although NHF might as well), it should have staff that are trained in this type of program design. Finally, the Renovation Fund should be structured such that it can access the capital market, as is the plan for NHF.

5.3.2 Public Policies for Infrastructure Development

Although infrastructure finance is not the major focus of this assessment, a brief discussion of public finance policies for housing-related infrastructure[74] is germane to a discussion of public housing finance for at least four important reasons:

- most obviously, a serious deficit in infrastructure development, especially housing-related infrastructure, is causing a **supply-side bottleneck** in new construction;

- long-term capital is a crucial element in funding for all three housing-related activities: new construction, major rehabilitation, and infrastructure. These activities are essentially **competing for long-term funds from a number of sources, including:**

  - -- national government subsidies,
  - -- private sector commercial credits, and
  - -- medium- and long-term capital market funds, including, for example, municipal bonds or debt funding by the NHF.

- long-term debt funding is just now coming into its own in Poland. Thus, gminas are beginning to **undertake assessments of their long-term debt carrying capacity**, and this type of analysis is crucial for all three of these activities; and finally,

- these activities all call on **scarce administrative resources** with regard to overall municipal planning, project design, obtaining long-term project financing, project management, and so forth. This is especially important at the gmina level but is also an issue for the staffs of the national subsidizing agencies.

In the last several years, infrastructure development has been an important national policy goal in Poland. The newly formed Municipal Development Agency (MDA), including assistance from USAID, is helping gminas analyze and plan their infrastructure goals, financial situation, long-term debt carrying capacity, and funding alternatives. Based on the level of funds available in the national budget for environmentally-sensitive infrastructure, a clear priority has been established to assist these types of projects, which include water, waste water, sewage, and solid waste. The 1997 budget includes approximately PLN 800 million for the National Fund for Environmental Protection (NFOS), including PLN 100 million for loans managed by the Bank for Environmental Protection (BOS). There are also state funds distributed through the voivods (so-called SPEC), amounting to PLN 90 million for 1997.

Some informed observers suggest that no additional national-level institutions are required for infrastructure assistance at the present time. As noted, the MDA is now active in technical assistance to the gminas; presumably its role could be expanded as required. **Thus, it may be that the NHF, which now includes infrastructure in its agenda, might wish to focus solely on not-for-profit housing and rehabilitation.** This suggestion is based, in part, on the considerable number of design issues still surrounding development of TBSs, other types of not-for-profit projects, and renovation/urban renewal. For example, the authors know of no criteria that have been developed whereby the NHF might choose among applications for not-for-profit housing, rehabilitation, or infrastructure should this situation arise in the future.

[74] The discussion in this chapter is limited to housing-related (and environmentally sensitive) infrastructure: that is, water, waste water, sewage, and so forth. Excluded are other forms of gmina capital investment such as roads, bridges, schools, and local public transport. Clearly, all these investments compete for funds.

Financing Infrastructure. Existing surveys of infrastructure investment needs suggest that there is a serious mismatch in many gminas between the extent of needed infrastructure investment and the financial capacity of the gmina to make the investment. Through the MDA, USAID is currently assisting in an assessment of the sources of funds used by gminas for housing-related infrastructure, especially via commercial credits, about which little is presently known. In approximate order of the share of financing, gminas now finance projects from the following sources:

- national/voivod subsidized funds;
- gminas' own funds;
- commercial bank credits (short- and long-term);
- municipal bonds;
- developer finance.

Just as for not-for-profit new construction and rehabilitation, the future will likely see the ordering of these sources of funds change, as private funding, especially municipal bonds, assumes a more important role. At the present time, however, the National Fund for Environmental Protection has been of tremendous importance to eligible (environmentally sensitive) infrastructure projects. Roughly 60 to 80 percent of these types of gmina expenditures may be funded through subsidized loans; the funds can cover up to 75 percent of project cost, and the subsidy can range from 30 to 45 percent of the NBP discount rate. Gminas' own funds are the next most important source; these are often utilized on a pay-as-you-go basis, resulting in an (unnecessary perhaps) extension of the construction period. Short-term credits from commercial banks are often used to balance gminas' annual deficits, since budgets are based on a cash rather accrual basis. Gminas are now being assisted in developing long-term, accrual-based approaches to budgeting; this will benefit all gmina projects requiring long-term funding, including housing.

Municipal bonds are the newest source of infrastructure finance in Poland, and although in their infancy now, are assumed to become the major source of financing in the future. In the last two years, there have been roughly 7 major issues (including Gdynia, Łódż, Ostrow Wielkopolski, Lublin, Gdańsk). Bielsko-Biala is about to select an underwriter for the largest issuance yet, planned at PLN 130 million. This funding would be dedicated to housing as well, although the scope of the project is not yet fully defined. Also, Ostrow Wielkopolski has satisfied all SEC requirements to have its municipal bond issue publicly traded.

In general, there is now extensive interest in municipal bond development. The MDA, HFPO, the British Know-How Fund, and USAID's Local Government Partnership Program offer considerable assistance to the gminas (and USAID's LGPP program plans expanded assistance over the next three years). This is also an extremely important aspect of capital market and financial sector development. Banks are competing for the role of underwriter. All municipal bonds issues so far have been done through private placement, which in Poland means fewer than 300 investors. Since disclosure is not required for private placements, little is known about the profile of investors; however, it is likely that at least the underwriting banks themselves and possibly Polish holding companies are participants. An analysis of the potential strength of the different investors would be a useful addition to the development of this type of financing.

Public Sector Assistance to Housing and Infrastructure. Many of the issues important to funding and efficiency in housing and infrastructure are closely related. There are both national and gmina level issues that need to be considered in tandem. Determining relative levels of need, for example, for new housing, rehabilitation, and infrastructure, is a public finance problem worldwide; under Poland's now decentralized structure, need is largely determined locally, but national budgeting must remain responsive to the local signals and requests. Similarly, as noted, all of these activities compete for funds and skills -- budgetary funds, commercial credit, long-term capital market funds, and administrative and project design skills. Gminas need to know not only how to develop both housing and infrastructure projects, but how to place these in their overall budgetary context and determine how much debt they can assume. The ability to compete for capital market funds and collaborate with private sector institutions is also crucial.

There are also improvements to be made in existing legislation. It has been suggested that improvements to the Local Government Finance Act are required, for example, especially to better define the legal authority of gminas to incur debt financing. Finally, the requirements for gminas to also fund non-infrastructure and non-housing activities calls into play the entire gmina fiscal structure and the inter-governmental fiscal system. Since these issues overlap all the sources of funds considered in this chapter, they are discussed together in Section 5.5.

5.4 Continuation of Housing Policy Reforms

Introduction. Transformation of centralized, public housing sectors into systems compatible with -- and supportive of -- market-based housing systems generally requires at least three major changes. One is to shift ownership out of the hands of central government, either into private ownership, to local government, or to some combination. The second is to introduce a market-based rent structure for housing subject to rent control and to assist poor households, not with subsidized rents, but with income support, such as a housing allowance program. The third major change is to promote increased use of the private sector in delivering housing services. This may involve a number of policies, including continuing the process of privatization of the public stock, privatization of housing management and maintenance services, and development of public/private partnerships for delivery of not-for-profit housing.

Poland has partially completed this process. A major goal of Polish housing policy since 1989 has been to transfer basic duties connected with housing planning and provision from the central government to gminas. That goal has been fundamentally achieved (although nationally-imposed rent ceilings still exist) and housing provision is now one of the gminas' major responsibilities. A process of reform of rent policies has been initiated and a housing allowance program is in place. However, in order that public housing sector policies not inhibit the development of a private (rental and ownership) housing sector, continued reform will be necessary. Sales of communal housing to individual owners have gone more slowly in Poland than in many of the other transition economies. In addition, rents, on average, do not yet cover current costs and rent-to-income ratios are still low by international standards. Similarly, provision for future capital repair will not be possible until rents are increased. Equally important, the **structure of rents** is only slowly beginning to move toward a market-based system, whereby rent in a given unit reflects the quality, space, and locational advantages offered by that unit.

Support for these types of market-based reforms has been worldwide, deriving from Western Europe, other transition countries, and a number of developing countries. In Western Europe in particular, where many countries have large public housing systems, the last two decades have witnessed increased privatization of units, increased privatization of management, increased citizen participation, formation of public/ private partnerships, and reform of rent structures to reflect free market pricing. **Thus, throughout the world, the efficiency and growth of the housing sector have been assisted by several basic reforms, as summarized in Box 5.1.**

Box 5.1
Key Goals of Housing Policy Reform:

- the private sector increasingly owns the housing stock and provides new capital for its growth;
- rent and subsidy policies in the public sector are consistent with development of the private sector; and
- government plays a strategic and enabling role, curtailing its own role as a direct provider and manager.

The following sections briefly discuss Poland's rent policy and housing allowance program, and offer policy reform suggestions designed to provide incentives to enhance development of the private housing market.

5.4.1 Rent Liberalization

The Act on Housing Rent and Allowances relaxed constraints on rent levels in rent-controlled units and allowed an increase in rents of up to 3 percent of the replacement cost of units (based on the voivod replacement cost index). However, the level of rent charged by gminas has remained much lower. In 1995 rents ranged between 0.9 percent and 1.3 percent of replacement costs. In comparison with Western Europe, the United States, and many other countries, including some of the transition countries, Poland has a relatively low rent-to-income ratio. Some gminas apparently increased rents in 1996. In the majority of gminas, however, rents do not yet cover costs. **In particular, rents generally do not cover current costs -- routine maintenance and repairs and administration -- and certainly do not cover the cost of accruing a contingency fund for capital repairs.**

Rent "structure" is an issue as well as average rent level. Some gminas have begun to develop strategies to differentiate rents away from "flat" price schemes, in which rents varied little with dwelling quality or location. It is now accepted in some gminas that rents for dwellings in good locations and in good condition should be higher than rents for poorer dwellings. This change will improve the efficiency of the allocation of the existing stock and will do so to a greater extent as rents rise. However, the process of development of gmina policies for this type of "structural differentiation" is still in its infancy. Both Western Europe and the United States have addressed the rent structure issue in their own public housing systems in the last several decades, and can offer methodological assistance and policy advice.[75]

[75] USAID and British Know-How have offered rent policy assistance in Poland over the last several years. USAID and the City of Poznan sponsored a Rent Conference in May 1995 which addressed the issues involved in creating market-based rent structures in public housing, including a hands-on description of possible methodologies. Tentatively, a follow-up conference/workshop will take place in 1997 to assess gmina strategies to-date in reform of rent policy.

Why have rents not been increased faster? Multiple benefits would accrue, including badly needed relief for most gminas' budgets. **Most important, however, without increased rents there is much less incentive for the development of not-for-profit housing by TBS or construction of market-rate rental housing by the private sector**.

Several reasons have been put forward in explanation of Poland's relatively low rent levels. First, observers feel that both rents and the issues associated with tenant claims on particular units have been difficult "political issues." As discussed in Chapter 2.0, policy reform in housing has tended to lag behind that in other sectors in Poland. Thus, implementing increases in rent level (per m^2) or changes in the rent level in one unit relative to another have not been popular policies.

Affordability is clearly a major problem for many households; thus, rent reform is also closely connected with **housing allowance policy**. A housing allowance program, if designed properly, should permit rent increases higher than those recorded to-date without serious problems for the poor. As discussed below, participation in the housing allowance program has been far lower than anticipated. The responsibility for implementing the allowances lies with gminas and they are also required to fund 40 to 60 per cent of the costs of these schemes. It has been argued that, in consequence, gminas have a strong incentive not to raise rents, as that will increase the expenditures on allowances in communal housing. Given the limited share of households who receive allowances, this concern may be greatly exaggerated. **As discussed below, however, failure to participate in the housing allowance due to fear of stigma or lack of knowledge of the program, combined with a housing allowance structure which may limit eligibility too severely, is a serious constraint to improved rent policy**.

Utility price increases may also have hindered further rent increases. About 70 percent of total housing payments, in houses which are fully equipped with utilities, are charges for hot water and heating. The prices of utility services increased markedly in the 1990s and are widely perceived by tenants as an increase in rent. The increased cost of hot water and heating is a result of not only of Poland's energy price liberalization, but also insufficient dwelling insulation and inefficient delivery systems. In any event, potential increases in rent are seen to have been **"squeezed out" by utility policy**.

Another obstacle to increased rents is said to be fear of a further increase in **rent arrears**. In 1995, 240,000 households in gmina housing were in arrears for three months or more. This represents 14 percent of the total gmina stock of 1.7 million dwellings. In addition, the difficulties of implementing effective **reallocation and exchange** policies in communal housing have hindered both mobility and adjustment of rent policies. A better matching of household needs to unit characteristics goes hand-in-hand with rationalizing rent level, rent structure, and occupancy goals. The issue of mandatory "replacement dwellings" for households that gminas wished to evict for non-payment, or to move to more suitable units, has been a difficult obstacle for gminas and is not yet fully solved. Finally, a number of gminas have already indicated that the rent ceiling of 3 percent of the replacement cost index will ultimately limit the rent structures they plan to develop in the medium term. **Thus, rent policy and arrears and exchange policies will all have to be modified, perhaps in the context of new legislative or regulatory mandates.**

5.4.2 The Housing Allowance Program

Housing allowances are a form of direct demand-side housing subsidies. Currently, eight transition countries in addition to Poland have implemented a housing allowance either on a nationwide or local basis. These include Estonia, the Czech Republic, Hungary, Latvia, Lithuania, Ukraine, Belarus, and Russia. In all cases the primary purpose for implementing an income-based subsidy was to protect poorer households from higher housing costs associated with the rent and utility increases that are needed to generate revenue for the operation and maintenance of housing.[76]

With an effective housing allowance program, transitional countries can fulfill multiple goals of housing sector reform. These goals are:

- to create a mechanism for guaranteeing a minimum level of housing services to lower income households;
- to help integrate communal housing and the emerging private rental sector and to grant households greater opportunity to choose the type of housing they desire;
- to use “market” rental prices to allocate housing and housing services;
- to better target subsidies to those households who truly need assistance; under rent control the subsidies accrue to poor and well-to-do households alike;
- to increase revenue to cover the cost of maintenance and operation; and
- most importantly, to stimulate the development of private rental housing by increasing the effective demand for alternative housing and housing services.

Surprisingly, to observers and policymakers alike, Poland’s housing allowance program has been under-subscribed relative to expectations. In 1995, less than 70 percent of planned spending on allowances was actually spent. In 1996, out of PLN 460 million allocated to allowances, only PLN 270 million (63 percent) was spent though the end of October. Presently, about 6.4 percent of households benefit from allowances, as compared to the estimated eligibility rate of over 20 percent.

One reason for this low participation rate is thought to be **ignorance about the program** due to limited promotion activities by gminas. A survey conducted in 1995 revealed that 19 percent of households surveyed did not know of the housing allowance system. The share of households who are not familiar with the program is even higher among older households, who are relatively more likely to be poor and to occupy older communal housing, and poor households living in overcrowded housing.

Another hypothesis for underutilization is the likelihood that **real incomes exceed recorded incomes**. Thus, households concealing their true level of income will not wish to undergo the checks associated with receipt of allowances. Non-participation due to income underreporting is part of a larger problem of accurate assessment of income, which impacts many national policies, both relative to income support issues and tax payment. Further increases in rent levels, as called for above, should solve some aspects of this problem. However, of much greater concern is lack of participation due to ignorance or fear of stigma. **Both the national government and the gminas should promote the housing allowance program, explain the benefits of housing reform, and educate the public to the beneficial role of the housing allowance in housing reform and income support.**

[76] Empirical studies in Western countries have shown that housing allowances are a more efficient subsidy mechanism (more and better housing provided for less cost) than supply-side housing subsidies that are linked or tied to housing production. In addition, it can be argued that consumer-based subsidies are a more equitable way of allocating scarce government resources than subsidizing the construction of public housing, since the latter subsidizes households who do not have an affordability problem as well as those who do.

There are three criteria that determine the eligibility for the Polish housing allowance program. They are: (1) income defined as percent of the lowest pension; (2) size of the dwelling; and (3) a predetermined fraction of income allocated towards housing costs. These criteria vary by household size.[77] Benefit levels are rather low (about PLN 55 per household per month) and the program as now designed only serves quite poor households. The share of households receiving allowances is higher in small cities than in larger cities, due to a higher unemployment level and a lower income level. The 1995 participation rate in cities below 10,000 inhabitants was 15.6 percent, while it was 4.8 percent in sample cities over 300,000.

The Housing Allowance Program, Affordability, and Not-for-Profit Housing. Unlike the housing allowance program, the TBS/not-for-profit program was designed to assist households of moderate income. Furthermore, as discussed in Section 5.2, the planned-for financial structure of TBS housing may still not be viable, requiring some combination of a deeper subsidy and/or higher rents. Clearly, this may push the target income group for not-for-profit housing somewhat higher. **These program parameters are of concern to the continued evolution of a market-based housing sector because there appears to be fairly significant group of households which, under current rules, would not be able to participate in either the housing allowance program or TBS housing.** In addition, as rents are increased, low income households not eligible for an allowance could face undue hardship.

Table 5.2 below provides an estimated household income distribution for Poland in 1994 (in quintiles, or five categories with equal numbers of households in each).[78] For example, a two person household which earns a monthly income of 549 PLN (which is at the second quintile of the income distribution) and lives in an average three-room apartment of 60 square meters would not eligible to receive a housing allowance. This same household would have to earn about 22 percent less income (or PLN 426 per month) and live in a unit no greater than 40 m^2 in order to qualify for a housing allowance under the current eligibility criteria.

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[77] A household is eligible if its total income per person is equal to or less than the lowest pension, or one and one-half of the lowest pension in one-person households; if the area of the dwelling unit that the household occupies is not larger than a predetermined size; and if the allowance covers the amount of housing costs in excess of 10 to 15 percent of gross income.

[78] Recent data for the income distribution (as opposed to income level) are not readily available. This income distribution was derived by Hanna Kulesza for 1994 data and reported in *Wydatki na mieszkanie w budżetach domowych* for GUS. These calculations use floor space of 60 square meters for a typical two-person household and average per capita income figures for Poland (rather than the voivodship) to calculate eligibility for the TBS program. **However, even though the income data are not current, the comparisons between housing allowance and TBS eligibility remain salient.**

Table 5.2
Illustrative Eligibility Ceilings:
Housing Allowances and TBS Housing
(PLN, 1994)

Household Income Distributions		Housing Program Eligibility Ceiling (PLN per month)
Quintile	Average Monthly Household Income (PLN per month)	
1	413	PLN 426: Housing Allowance Program
2	549	PLN 588: TBS Program
3	695	
4	925	
5	1287	

Households able to participate in the TBS program would have to have higher incomes than those eligible to receive housing allowances. As discussed, the not-for-profit housing program is not designed for the poor but rather for households with modest/moderate income. Thus, the eligibility threshold is much higher. For example, a two person household could be eligible to participate in the TBS with an income of roughly PLN 588 per month (1994 income).[79] Rent payments for TBS households might amount to roughly PLN 150 per month on average.[80] This figure is about three times as high as the typical rent payment (PLN 50 per month) found in municipal rental units of similar size.

Given the current design of the housing allowance, the program is likely to fail to meet the needs of poor households as rents are increased. **The problem lies not in the "gap" formula of the housing allowance, but rather in the income eligibility ceilings and the floor area limitations.** In the current housing allowance formula, the "subsidy" payment rises as rent increases (and thus the gap between rent and a given proportion of household income increases). However, this "safety net" feature of the program will not come into effect for many households that are ineligible for the housing allowance, because they violate the income ceilings (or the floor area criterion).

As an example, assume that the household described above had a monthly income of PLN 430, just above the eligibility limit for assistance. Assume next that their rent in communal housing had been increased to PLN 150; this results in a rent-to-income ratio of 35 percent, even before utilities are considered. Thus, there

[79] This calculation is based on program limits of 80% of average earnings for a two-person household. We use PLN 735 per month as the average income for Poland in 1994 instead of average earnings. Refer to the footnote on the previous page for the source of the data.

[80] This calculation is based on rent levels consistent with typical cost of labor and materials for a 60 square meter residential housing unit with rent set to capture 4 percent of the replacement cost as stipulated by TBS design parameters. Refer, however, to the discussion in Section 5.2; if TBS projects are to be viable and/or allow for outside commercial financing, rents may need to exceed the 4 percent ceiling.

appears to be a "gap" in the income support policies which will make it difficult for gminas to increase rents without causing some hardship. The consequences are as follows:

- If gminas were to increase rents to cover current (and perhaps capital) costs, and furthermore were to adopt a rent structure roughly consistent with rents for similar units in the market sector, it appears that some households would not be adequately protected by the housing allowance because of its restrictive eligibility requirements. Although an increase in rent-to-income ratios is generally called for in Poland, there are poor households at risk of facing an excessive burden.

- However, many of these same households, which are above the income limits for participation in the housing allowance program, would not be financially able to participate in TBS housing because expected rents in TBS projects will be too high for them to afford.

In summary, gminas are urged to increase rents in communal housing, both to cover costs and to provide incentives for development of a private rental sector. As a consequence, it will be important to evaluate the design of the housing allowance program to ensure that it meets its social safety net objectives. This is essential if rental housing is to be supported by private funding; private finance will only follow higher rents, and higher rents will mean undue hardship for the less affluent if the allowance system is not well structured and promoted.

At the same time, however, the housing allowance can hardly be an "open-ended" program to pay for whatever differences occur in rent and the (formula-determined) ability to pay of a household. Thus, many countries now utilizing the housing allowance approach have adopted an alternative formula for the housing allowance benefit. Rather than having the "gap" aspect of the formula be defined as the difference between actual rent and a household's ability to pay, the eligible rent figure in the formula is capped at the "cost of a standard unit" (also delineated by household/unit size rules). In addition, as has occurred in the West, Poland should at the same time impose higher rent-to-income ratios in the formula, especially for household of at least modest income. This type of change should be accompanied by a liberalization of the eligibility criterion for housing allowances: the income ceiling should be increased and consideration given to dropping the floor space limits. These changes would accomplish three important policy goals:

- more households would be eligible for housing allowances, allowing gminas to increase rents without causing undue hardship;

- the housing allowance benefit would be "capped" by utilizing a new formula which does not consider actual rent but rather "rent for an adequate unit of a given size." Thus, subsidized tenants would have to move to units affordable to them; and

- the apparent "gap" in eligibility between households who would be assisted by housing allowances and those who might be assisted by TBS/not-for-profit programs would be narrowed.

In summary, it is recommended that a comparison be undertaken of the current housing allowance program and several alternative approaches to determine the costs and benefits of each. Simulations should be undertaken based on alternative rent structures, alternative rent-to-income levels, a revised housing allowance formula, and revised eligibility criteria.[81]

[81] We suggest that a quantitative analysis using current data be undertaken to assess the extent of the "gap" in eligibility and how it might be addressed.

5.4.3 Privatization and Reallocation

The previous sections have discussed revisions to rent policy and housing allowances. Three closely related topics on the policy reform agenda are (1) privatization of the communal stock; (2) policies allowing for exchange of units and reallocation of households within the existing stock; and (3) policies allowing penalties, and ultimately eviction, for non-indigent households which do not pay rent arrears. Together with rent and housing allowance reform, continued progress in these areas would put Poland well on the way to creating an efficient public rental sector and maximizing incentives for growth of the private and not-for-profit rental sectors. However, progress still needs to be made in these areas.

Privatization. As noted above, sales of communal housing to sitting tenants (introduced in the provisions of the "Ownership of Units Act") have been slow in Poland, at least in relation to privatization rates in some other transition countries. The most attractive housing stock was sold in the early 1990s. Estimates indicate that by early 1996 just under 15 percent of the gmina housing stock had been privatized. **One major reason for the slow rate of privatization is undoubtedly the low level of rent still prevailing in most communal housing: if households that could afford to own their units continue to be subsidized, there is little reason to change their tenure status.** A second problem for these households, however, is the high cost of rehabilitation of many of the units; thus, Poland should finalize its plans for the Renovation Fund as soon as possible, to allow households (and gminas) to determine whether assistance might be available.

One outcome of the limited privatization process has been the emergence of a large number of residential buildings with mixed housing tenures and multiple ownerships, as gmina tenants coexist with condominium owners. Thus, it will become increasingly important to develop appropriate management and maintenance systems for mixed-ownership buildings. At present, even if part of a building is privatized, management still remains a gmina responsibility. Out of 20,000 condominiums in a Housing Institute survey, only 210 took independent responsibility for managing the property. The remainder continued to rely upon public management enterprises. Several reasons for this continuing pattern were revealed in a survey of gminas by the Institute of Public Affairs, conducted between August 1994 and June 1996, and involving 128 gminas of different sizes. The survey revealed the following:

- in four out of five gminas, the housing authorities either disregarded or did not understand the Ownership of Units Act;
- eight out of ten gminas had little or no confidence in the responsibility and good will of co-owners and emphasized their incompetence and inability to carry out obligations imposed by the law; and
- in six out of ten gminas, housing management staff showed no willingness to engage external experts or utilize modern methods of property management.

Gmina resistance to change was also reinforced by the attitudes of co-owners in condominiums. Only half the co-owners believed that the new property rights they had in relation to undertaking building management and maintenance also carried an obligation to pay for such work. And of the group that recognized their new rights and responsibilities, the majority saw lack of financial resources to undertake such work as a key difficulty.

Reallocation and Eviction. Observers note that gminas have found it difficult to reallocate households among existing units in order to better match household and unit characteristics and households' ability to pay. In part, gminas themselves may be reluctant to impose "unpopular" policies. In addition, however, gmina officials have noted that several recent court decisions concerning reallocation of tenants have resulted in a conservative posture in favor of strong tenant rights. This, in turn, restricts the ability of gminas to: (1) implement reallocation policies; (2) implement rent restructuring policies which then allow households to seek preferred units; and (3) to address rent arrears. Ultimately, if all other approaches fail, non-indigent tenants should be evicted for failure to pay rent.

5.4.4 Summary: Policy Reform Recommendations

While Poland has made considerable progress in introducing policies to support the evolution of an effective public rental sector, an "unfinished agenda" of reforms will continue to inhibit privatization and development of parallel private and not-for-profit housing sectors. The following recommendations summarize the authors' views on the next steps that should be taken:

Rent Policy

- **Increases in average rent level** should allow gminas to fully cover the costs of current expenditures on maintenance and administration and to begin to accumulate the funds necessary for future capital repair. (A capital repairs/rehabilitation "backlog" also exists in much of the stock; estimates of these repair requirements should also be made, but the costs will be difficult to cover out of current rents.)

- **Rent structures** should be similar to those in market-based housing. Rent should reflect the quality, size, neighborhood, and locational features of the unit.

Housing Allowance Policy Reform

- The Housing Allowance program should be reviewed and revised to ensure that it is adequate to support target households as rent levels increase. This includes an analysis of eligibility rules (both income ceilings and space limitations) and a review of the formula (both to cap the benefit at a reasonable level as rents rise and to ensure adequate household contribution).

- The combination of increased rents and a revised housing allowance program will allow gminas to establish clear and transparent policies for both subsidies and rents.

Privatization

- Rent reform policies should encourage further privatization of the communal stock. Rehabilitation policies should be put into place quickly to assist gminas and households to make privatization decisions.

- Privatization of management and maintenance services, including transfer to TBS, should also be encouraged.

Reallocation of Households in Communal Housing

- As rent structures evolve, thereby differentiating units by quality and location, an effective exchange policy is required. Households willing and able to pay more for better units should be able to exchange dwellings.

- A process of household exchanges within the stock is also necessary to implement policy reform in rent levels and housing allowance payments. Poor households will receive adequate support; however, only households that require assistance will receive it. Non-indigent defaulters should be required to leave.

5.5 Conclusions and Recommendations: Funding and Assistance Issues in Public Housing Finance and Infrastructure

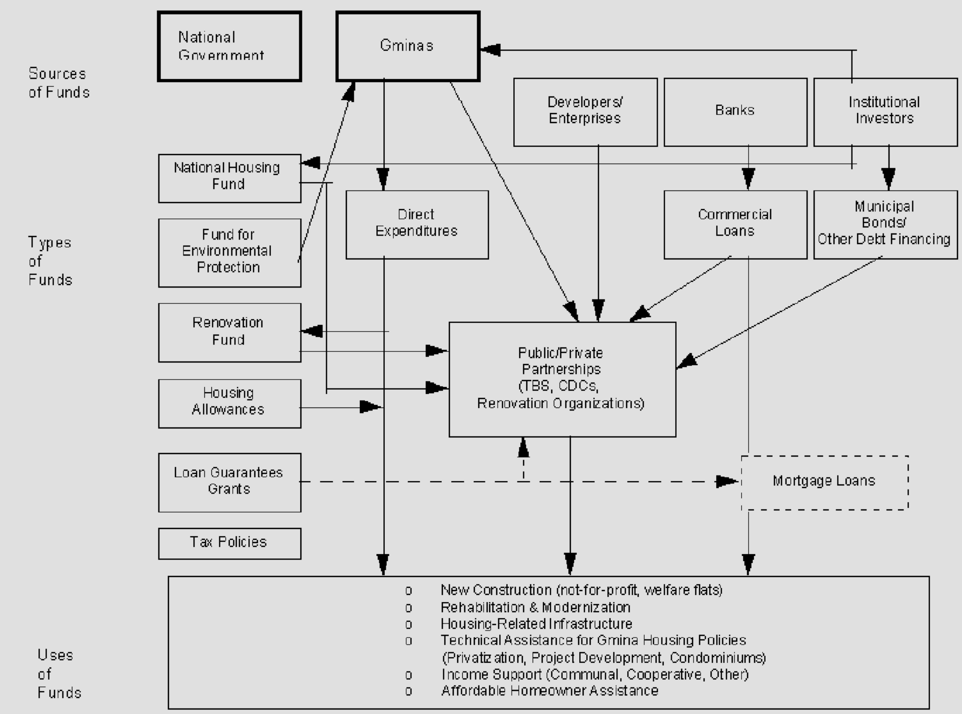
Figure 5.2 proposes a structure for Poland's public housing and infrastructure finance system in the near future. The structure builds on the public finance initiatives now in place, or nearly in place, for not-for-profit housing, rehabilitation, and housing-related infrastructure. Thus, the proposed structure does not alter the existing institutional arrangement but rather seeks to clarify the policy goals and to enhance the connections to sources of private funding. Although the roles of the national government and particularly the gminas remain crucial, various forms of public/private partnership increasingly take center stage. These partnerships will take many forms: TBS, renovation organizations, funding consortia, Community Development Corporations,[82] and so forth. In summary, the evolving structure would accomplish the following:

- greatly enhanced interaction between the public and private sectors, both at the national and gmina levels, including

- increased utilization of various public/private partnerships and funding consortiums, including TBS, CDCs, independent renovation organizations, and various types of co-funding arrangements among gminas, banks, the capital market, and the national subsidy mechanisms;

[82] CDCs, Community Development Corporations, are a form of public/private partnership widely used for urban renewal and housing development in the United States.

Figure 5.2
Poland's Public Housing Finance System: 2000



- increased capital market funding of gmina-level initiatives, including municipal bonds for both infrastructure and housing, capital market funding of NHF programs, and possible debt financing for various public/ private partnerships;

- increased attention to incentives which link the private sector to affordable housing initiatives, such as grants to first time home buyers, NHF loan guarantees for eligible home purchasers, and/or mortgage interest tax deductions for moderate income households; and

- decreased direct involvement by gminas in housing management and housing ownership, via further privatization, encouraged by the types of rehabilitation, housing allowance, and rent policies which support privatization.

In order to assess whether the present structure can effectively evolve into the public/private partnership system envisioned in Figure 5.2, the discussion in this chapter has sought to address the following questions:

- Is the existing institutional structure able to effectively pursue Poland's public housing and infrastructure finance goals?

- Are subsidies formulated in the most effective manner? Are there sufficient incentives for leveraging funds from the private sector?

5.5.1 Institutional Structure

The National Housing Fund, the MDA, the Fund for Environmental Protection, and the proposed Renovation Fund provide important subsidy distribution and/or technical assistance mechanisms for housing and infrastructure. Thus, it does not appear that additional national government transfer mechanisms are required, at least not at the present time. Rather, continuing with three themes that have already been initiated should serve to strengthen the existing institutional structure. These are: (1) continued review and improvement of the details of existing or proposed initiatives; (2) an ongoing attempt to sort out the roles of the existing institutions to maximize the focus of each; and (3) continued strengthening of linkages to the private sector, whether funding institutions or public/private consortiums.

As has been discussed, many of the new programs could be assisted through redesign of some of the parameters. For example, TBS initiatives may need to be stimulated through deeper subsidies and/or different rules for rent ceilings. Also, continued public debate over the form of assistance to renovation will undoubtedly improve the effectiveness of subsequent initiatives in implementing renovation. In addition, many of the new policies must interact with one another to achieve their various goals. For example, unless rent policies in communal housing are altered, incentives are weakened for both households and private investors in cooperating with gminas to produce the types of public/private partnerships desired under the TBS; correspondingly, the housing allowance program must be able to support a new rent structure.

A review of institutional focus is perhaps most important for the NHF. To date, the majority of activity surrounding utilization of NHF funds has dealt with development of not-for-profit housing through TBS. Even though the NHF has stated that its goals also include infrastructure development, it is perhaps more efficient for the NHF concentrate solely on not-for-profit housing construction and rehabilitation. As discussed, the project design and financing skills required for both the gminas and the NHF to launch effective not-for-profit programs are considerable. Similarly, unique design considerations exist for renovation and urban renewal, which are complex topics worldwide. Thus, a pertinent goal for the NHF might be to limit itself to housing concerns.

5.5.2 Determining "Need" and "Relative Need" for Public Finance for Housing and Infrastructure

Public housing and infrastructure finance: is there a gap? The discussion in this chapter noted the very problematic nature of this question. First and foremost, this is because of the inherent difficulty in defining need. Under Poland's now decentralized structure, gminas are largely responsible for assessing the need for new housing, rehabilitation, and infrastructure. Local experience with decentralization, especially in conjunction with the national subsidy mechanisms, is in its infancy and local economic conditions are changing rapidly in many places. Secondly, with regard to "relative need," there are no explicit criteria for establishing priorities among these three activities. Again, an assessment of **relative** need will emerge from political and spending decisions at the local level and applications for assistance to the relevant subsidy mechanisms. **Under these circumstances, the recommendation for the national budget was that policymakers dealing with housing and infrastructure work together to respond in a flexible manner to emerging requests.**

It is likely that the current level of public funding may be inadequate to address the immense problems facing infrastructure and housing. As has been discussed, public finance for housing will continue to be severely constrained until the vast majority of past subsidies is paid off. It is also difficult to gauge the need for construction of not-for-profit housing because so few proposals have been received by NHF at present. Even so, the level of funds allocated to NHF (even if the PLN 120 million are supplemented with an additional PLN 160 in 1997) seems quite limited, especially in a situation of very depressed levels of new construction. With regard to rehabilitation, at least there is an estimate available: 570,000 units that are said to require urgent modernization to avoid demolition. If this figure has any claim to accuracy, the draft legislation for the Renovation Fund is inadequate. Finally, as was noted above, the need for infrastructure far outstrips the ability of gminas to finance it at the present time.

To simply call for additional public funds begs the question, however. Clearly, more funds could probably be effectively utilized, particularly in the medium term. Requests for additional funding should be based on two considerations: (1) need at the local level, based on well-formulated gmina project design proposals and applications for assistance; and (2) conformance with Poland's quest for fiscal austerity. Funds should not be delivered at an overall budgetary level that would weaken the fight against inflation, which is probably the single most important deterrent to long-term finance, private or public.

We presume that better estimates of need will emerge as the housing policies of the gminas, in conjunction with the NHF and the Renovation Fund, become more focused and are based on solid project requests. Thus, in order to determine a relative order of magnitude of need for the various housing and infrastructure funds, national policy makers need to make a continual assessment of local demands. Gminas, on the other hand, need to be able to effectively communicate with national policymakers so that an appropriate share of the subsidized funds is available for each purpose. In this regard, both the various association of gminas and possibly the Ministry of Finance need to be actively involved.

As noted in the introduction, an additional challenge, therefore, lies in achieving efficiency goals in public sector finance policies. These include: **(1) efficiency and targeting of subsidies; (2) better strategic planning, both within gminas and across the national agencies; (3) better leveraging of private capital; and (4) transparency and public education about rights and responsibilities under the new policies.** Public housing finance must work towards the following:

- establishing better **estimates of the need** for public sector housing funds on the relative requirements for new construction, rehabilitation, and infrastructure;

- designing policies that **subsidize only recipients (gminas or households) who cannot otherwise pay;**

- targeting incentives that achieve **maximum leveraging of private funds --** both personal household funds and those accruing via the financial and capital markets;

- **assisting gminas** become better project designers and strategic managers in order to formulate long-term policies for privatization, affordable housing, and participation of private capital; and

- developing transparent policies that reflect **Poland's desired balance between tenant and owner rights** and which assist with public education as to the need for changes in housing policy.

Finally, the need for housing and infrastructure subsidies must also be considered in the context of the overall intergovernmental fiscal system. Gminas are responsible for far more than housing and infrastructure; education and health are among the other major contenders for funds. The process of allocation among competing demands goes on within gmina funding debates. At the national level, however, policy makers must continue to review the structure of local revenue powers and central/local transfers to determine what will best enable gminas to meet all their needs.

5.5.3 Enhanced Private-Sector Participation

Given the depressed condition of the housing sector, the high cost of new housing relative to income in Poland, and the needs expressed for rehabilitation and infrastructure, public housing finance will continue to play a very important role in the near-term future. However, as the private housing finance sector matures and expands and takes its place beside public sector funding of housing, policies must be set in place so that both sectors can support one another and operate in a coordinated fashion toward common goals. Based on experience in the Western economies, and reflecting the reform policies Poland has put in place, it is necessary and desirable that the role of private housing and infrastructure finance will continue to increase. Public housing finance will need to become increasingly supportive of private efforts and private finding, rather than dominate them as in the past.

Improving the interaction between the private and public sectors includes amplifying a number of important links that are now being developed or considering policies not now in place. Figure 5.2 has tried to suggest these links. In Figure 5.2, it is assumed, for example, that the National Housing Fund will need to obtain some of its funding from the capital market. Similarly, gminas will increasingly obtain funding through municipal bonds and commercial credits. Various types of public/private partnerships could become funding consortiums, combining own funds, subsidy funds (including those from the NHF and the Renovation Fund), and commercial funds to undertake construction and rehabilitation projects. As discussed below, banks could provide mortgage loans to a greater number of households through policies of grants and/or guarantees for first-time homebuyers.

However, more experience with the pricing of capital and the design of subsidized projects is required before the potential for these linkages is able to be better assessed. Pricing issues will probably be very difficult. Possibly, institutions such as NHF might have to consider various guarantee schemes that would make participation more acceptable to the private sector. The national government can help in several ways, undertaking, for example, an analysis of potential investors in municipal bonds, a comparison of the advantages and disadvantages of public and private issues, and, as mentioned, a continued review of the funding and subsidy structures of successful and unsuccessful projects. Finally, continued technical assistance to the gminas, as discussed below, will be essential.

5.5.4 Assistance to Gminas

Gminas require continued technical assistance in several key areas, including analysis of overall financial profile/debt-carrying capacity, project design, access to private sector funding, and strategic planning. Public education and citizen participation are also important new topics. The national government's role in these efforts is one of both direct assistance to gminas and facilitation and guidance of donor activities.

- **Analysis of Gmina Overall Financial Strength.** Gminas reserve funds in their budgets for their numerous responsibilities, including housing and infrastructure. Gminas must learn to look globally at their total investment program -- to add it up and see whether it can be funded and how it can be financed. They also need to change annual planning into medium- and long-term. Improved financial analysis capacity, with emphasis on long-term debt carrying capacity, will be increasingly important to gminas. Long-term debt financing should be done in conjunction with both long-term planning and project design. Project design assistance also includes bidding procedures, evaluation, and negotiation.

- **Gmina Access to Commercial Funds and Access to Long-term Capital Market Funding.** Hand in hand with project design, gminas need to develop further skills in the ability to access both loans and municipal bonds. Obtaining long-term loans, for example, requires contact with banks interested in municipal lending, and completion of loan applications based on adequate project design. Similarly, funding through municipal bonds involves determining which type of bond and placement is appropriate, developing a prospectus and/or information memorandum, and determining underwriter bidding procedures.

It should be emphasized, however, that market rate debt financing will be available only for bonds/loans secured by all gmina revenues. This means that gmina debt issued for housing construction, renovation, or infrastructure purposes will compete within the limited financing capacity of the gmina, both with each other and with all other investments.

- **Strategic Planning for the Housing Sector.** National policymakers and donors can also assist gminas to take an **increasingly indirect role in the housing sector** via increased privatization, public/private partnerships, and assistance to condominium associations. Based on experience in Western Europe and the United States, this model, rather than one of ownership and/or direct management of all the communal housing stock will likely prove more cost-effective.

- **Public Policy and Citizen Participation.** In Section 5.4, the importance of market-based rents and more flexible allocation and tenure policies for communal housing was underlined. These policies, in combination with the income support offered by housing allowances, will not necessarily be popular nor easily understood. Current practice in many countries suggests that tools are needed to educate citizens regarding policies that may be unfamiliar but are strategically appropriate to long-term development. Thus, gminas might be assisted in conducting focus groups, surveys, public meetings, and other forms of public communication.

5.5.5 Formulation of Subsidy Policy: Subsidy Structure and Targeting by Income Group

The final topics are ones which Polish policymakers are presently debating: (1) what form subsidies should take -- particularly whether grants or subsidized loans should be utilized -- and (2) whether the public policies now in place fully address all the relevant segments of the income distribution.

Subsidy Structure. The authors prefer the grant approach to that of subsidized loans. Subsidized loans pose several major risks, including: (1) perpetuation of the distortions in the financial sector that Poland has been working to eliminate, (2) creation of a disincentive to private sector participation if the subsidized loans are not well targeted, and (3) more difficulty, in some cases, in targeting recipients who are eligible for the assistance. This type of debate is now being waged, for example, with regard to the Renovation Fund, which currently proposes to offer both loans and grants. The general principle is that grants provide a very direct way of allowing a recipient -- a gmina or a household -- to decrease cost but do not introduce price distortions into the structure of interest rates. For TBS housing, for example, a grant approach would allow the TBS to buy down the cost, but also force it to seek market rate funds for the remainder of what was needed. The disadvantage for the GOP, of course, is that this requires more funds up front than the interest rate subsidy approach.

The principle of minimizing market distortion also holds for rent policy. Again, the authors support the introduction of market-based rents for communal housing. When rents are held well below true costs, the "subsidy" assists those who are not eligible as well as those who are. Low-income households should be assisted with housing allowances, rather than with rent control.

Targeted Income Groups. The extent to which existing programs cover all income groups in providing affordable housing may be incomplete. Two groups are of concern. The first group includes those not eligible for the housing allowance but who could afford neither TBS housing as it is now planned nor communal or other housing with a market-level rent structure. The second group involves an issue of both affordability and tenure choice: modest income households that cannot now afford to become owners, either of flats or single-family homes.

- **Housing Allowance and Rent.** As discussed in Section 5.4, the current design of the housing allowance restricts eligibility to quite low-income households. If, as we propose, rents are increased to at least cover costs (short- and long-term costs), some allowance recipients may face an affordability problem. (Affordability is a relative concept. A rent-income ratio of 25 to 30 percent is now generally the rule in the West; Poland is far from reaching this level.) Other households, not now eligible for housing allowances, but close to the eligibility limit, could also face problems. This group of "low-moderate" income households tends to be an issue in most countries; in the United States they are often referred to as the working poor. Complicating this issue is the fact that there are fewer housing allowance recipients than anticipated. This either suggests that real incomes are higher than recorded incomes and/or that the stigma or inconvenience of receiving an allowance has deterred the household from participating. The latter is of concern regarding affordability; the former because of the difficulties it poses to program design and implementation. Furthermore, the housing allowance formula should be modified; in most other countries the formula does not utilize actual rent but rather a particular rent level which represents the cost of a standard unit. Thus, we recommend that an analysis be undertaken to review alternative rent and housing allowance structures.

- **Affordable Rental Housing.** Assistance to moderate income households in affording rental housing was expected to be addressed via the TBS approach. If, however, the rent levels under the NHF/TBS structure need to be increased in order to produce viable projects, some portion of the original target group will not be able to participate. These same households would also not be eligible for housing allowances. The options include deepening the subsidy under TBS and/or enhancing the allowance program. It is likely, however, that both of these options will leave a group of modest-income households who have very few choices in affordable housing. Just how large this group might be cannot be easily determined. Thus, again, we recommend a study of options, using a simulation of alternative TBS pricing structures.

- **Affordable Home Ownership.** Finally, no assistance is now available to modest income households seeking affordable home ownership. And, as discussed in Chapter 3.0, loan-to-value ratios are currently particularly low in Poland, which adds to the difficulty of purchasing a home. Polish policymakers might wish to consider encouraging home ownership (including condominiums) for moderate income households. In nearly every country, these households have difficulty moving into home ownership; the assistance they receive is designed to enhance the affordability of the home and/or reduce the lender's risk resulting from higher than desired loan to value ratios. One approach is to provide eligible first-time buyers with one-time grants, and another is to guarantee some or all of the loan. The United States has had extensive experience with various types of loan guarantee programs; there is also no reason these two components cannot be combined. Admittedly, however, grants are "expensive" in that they require up-front funds, and guarantee programs can be difficult to operate. Finally, tax deductions for mortgage interest payments can be considered as well, although this remains a somewhat controversial program when the right is extended to all households, because it then becomes very regressive and expensive to the Treasury. It is perfectly plausible, however, to offer the benefit only to qualifying households of moderate income.

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APPENDIX B -- SCOPE OF WORK

ASSESSMENT OF THE FUTURE OF THE HOUSING FINANCE SECTOR

Objective

The objective of this study is to conduct an assessment of the status of, and prospects for, development of the housing finance system in Poland which will:

(a) Provide participants* in Poland's housing finance sector with a critical overview of the current status of the sector, including opportunities for, and constraints on, its development;

(b) Identify the main choices open over the next 3-5 years to those organizations and institutions which formulate or influence laws and regulations that influence the housing finance sector; and

(c) Provide USAID with a menu of recommendations for possible technical assistance interventions over the next two years.

***** "Participants" in the sector include the Government of Poland (notably the Sejm Committee on Housing, the Ministry of Construction, the Ministry of Finance, the proposed Housing and Urban Development Office, and the National Bank of Poland), Bud-Bank, BGK, commercial banks engaged in construction and mortgage lending, developers, local authorities ("gminas"), Polish consulting firms, and USAID and other donors, including their contractors. These groups are to be considered the main customers for this assessment.

Scope of Work

General Context and Guidance

The assessment will cover all relevant aspects of the provision of capital finance for new housing and housing rehabilitation in Poland provided through the market, and by central and local government. The scope thus includes finance for non-subsidized and for social housing, and finance for owner-occupation and for rental housing. The study will cover the areas of responsibility of the Mortgage Fund and the National Housing Fund (insofar as this relates to the construction of new housing, the rehabilitation of existing housing and management of the contract savings program), as well as of non-participating banks and other institutions.

Except where necessary to provide a context, the scope of the assessment will not focus on informal housing finance and finance provided by corporations and enterprises. Nor will it cover questions of gmina budgeting, such as asset management, or financing of maintenance and routine repairs.

The scope will also exclude coverage of land and infrastructure finance, and finance for the rehabilitation of districts or groups of buildings.

Because the development of training institutions for housing finance is the subject of a separate study and conference, this assessment will also avoid detailed treatment of this subject.

The report will assume that the readers are already broadly familiar with Poland, its political and economic environment, and its institutions, and so will not need to describe these basic features of the existing system. The report will also presume its readers are familiar with the subject matter of USAID's 1995 Report on the Status of the Polish Housing Sector *(Report on the Status of the Polish Housing Sector,* Amy Hosier and others. The Urban Institute, for PADCO and USAID/Warsaw, June 1995).

In order to obtain the most current information and opinion to undertake this assessment, the team will meet with and interview key officials responsible for housing finance policy, implementation and analysis, including representatives of the Ministries of Finance and Construction, Bud-Bank (responsible for managing the Mortgage Fund) and BGK (responsible for managing the National Housing Fund), a sample of commercial banks, the Housing Finance Project Office, PADCO/Warsaw, and other locally-based consulting firms, among others.

Task 1: Preparatory Work

Before starting work in Warsaw, the team members will familiarize themselves with recent literature about housing finance in Poland.

Task 2: Prepare an Analytic Overview of the Present Situation

The team will update the main issues discussed in the 1995 sector report. In doing so, they will address the following issues:

2.1 Provide a comparative description and commentary on the various existing and proposed sub-systems for providing housing finance to different target groups in Poland. To what extent are these sub-systems compatible and complementary? Do they meet the relevant social and economic objectives of the Government of Poland? To what extent are members of any group not readily able to gain access to housing finance? Assess the degree to which housing is affordable in Poland; to the extent that this differs from international norms, comment on the reasons.

2.2 Quantify housing finance activity in Poland, in order to indicate its economic and financial significance, and its real impact. Compare the Polish situation with that in other countries of similar economic development. Where possible, use internationally-accepted development indicators.

2.3 Identify the government policies and practices (including taxation policies) that influence demand for mortgage finance.

2.4 Summarize differences in the legal systems relating to non-subsidized housing finance between Poland and countries with more mature housing finance systems. Report opinions of Polish experts on the need for further change in Poland, and provide a commentary on relative priorities.

2.5 Characterize the systemic risks of non-subsidized housing finance in Poland. To what extent is a competitive, efficient, and equitable market developing? What are the principal constraints? Explain how they affect the development of a comprehensive housing finance system.

2.6 Summarize the relevant assistance programs of the principal external agencies (including USAID, World Bank, EBRD, British Know-How Fund, German Mortgage Bankers Association).

2.7 Analyze the effectiveness of the HG loan.

Task 3: Analyze Alternative Futures for Housing Finance in Poland

3.1 Based on the preceding analysis, and assuming that currently-proposed legislation will be implemented, the team will formulate alternative scenarios of how the housing finance system could develop within the next, say, five years. These scenarios will be based on the team's assessment of expected changes in the macro-economic environment, and of other factors that will have a bearing on the development of housing finance in Poland. The team will clearly spell out (a) their assumptions, and (b) what legislative, regulatory, institutional, and other changes would be needed for the different scenarios to become reality.

3.2 In particular, the team will state their views on the impact on non-subsidized lending of the new Mortgage Bank Law. Will mortgage lending in Poland be dominated by specialist mortgage banks, or will there also be room for other players? What conditions are necessary to establish an efficient market in mortgage bonds? Will there continue to be a need and demand for a secondary mortgage facility (such as the Mortgage Fund) in the future? What would be the characteristics of a transition from the present to a future system? If there is need for existence of the Mortgage Fund beyond its present funding limits, how could its future funding best be structured?

3.3 Examine recent developments and comment on: rehabilitation finance, infrastructure finance, and state liabilities in the housing sector.

3.4 The team will discuss to what extent the present initiatives in the development of social housing systems are likely to meet Poland's needs. How could any shortfall be met?

3.5 The team also will suggest what public sector initiatives (other than those which have already been announced) would further encourage the efficient and equitable development of the housing finance sector in Poland.

Task 4: Identify Options for Future Technical Assistance

4.1 During the course of the interviews in Tasks 2 and 3, the team will solicit opinions from interested parties about technical assistance (TA) needs for the sector, whether from foreign or Polish sources. Team members should emphasize that they are advising, not representing, USAID and, therefore, that they are neither able nor authorized to make any commitments about future TA.

4.2 From this information, the team will form their own judgement as to which activities, if any, could usefully be provided by Polish or foreign TA in order to assist development of the sector. Based on this analysis, and on the Mission's Results Framework, the team will provide USAID with a menu of recommendations for possible technical assistance interventions over the next two or three years.

Task 5: Prepare a Report

5.1 While in Warsaw, the team will prepare a summary of the findings and recommendations which correspond to the questions in Tasks 2 to 4 above. The summary will be presented at a review meeting with key Polish participants, to be hosted by the Urban Institute. The Urban Institute will provide USAID with preliminary draft chapters of the final report before leaving Warsaw. The team will submit the final version of the report, in English and Polish, in January 1998.

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