THE CURRENT OPERATION OF THE BAUSPAR SYSTEMS IN THE CZECH REPUBLIC, HUNGARY, AND SLOVAKIA

Prepared for

USAID

East European Regional Housing Sector Assistance Project
Project 180-0034
U.S. Agency for International Development
Contract No. EPE-C-00-95-001100-00, RFS No. 64

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September, 1998
UI Project 06610-645

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ABSTRACT

This document describes the history and current operations of the Bauspar systems in three Central European (CE) countries: the Czech Republic, Hungary, and Slovakia. It is based on interviews and data collected in June 1998 as part of a study of the transition in housing finance in these countries. Each of these countries has adopted a version of the German and Austrian system of separate contract-savings banks for housing, or "Bausparkassen." It is most likely premature to evaluate the achievement of the four goals of Bauspar systems, namely (1) to subsidize housing, (2) to increase savings, (3) to indicate credit-worthiness, and (4) to create a pool of stable funding. However, policymakers in the Czech Republic and Slovakia suggest that the system has been a disappointment in terms of real effect on the housing market relative to the outlay of budget resources, at least in the period until the low rate loans become commonly available, and in each country the large advantages to participating have actually introduced an element of instability where none existed previously. However, it is most likely premature to evaluate the achievement of the four goals of Bauspar systems, namely (1) to subsidize housing, (2) to increase savings, (3) to indicate credit-worthiness, and (4) to create a pool of stable funding. What is certain is that the maturation of the Bauspar systems will greatly expand the amount of borrowing for "housing purposes."

This document was prepared at the request of USAID/Warsaw. It reflects solely the knowledge, understanding and views of the author, and has not been reviewed by authorities in any country or by USAID.

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DRAFT REPORT

OVERVIEW AND SUMMARY

Introduction

This document describes the history and current operations of the Bauspar systems in three Central European (CE) countries. It is based on interviews and data collected in June 1998 as part of a study of the transition in housing finance in these countries. It reflects solely the knowledge, understanding and views of the author, and has not been reviewed by authorities in any country or by USAID.

Goals of Bauspar Systems

The Czech Republic, Hungary, and Slovakia have adopted versions of the German and Austrian system of separate contract-savings banks for housing, or "Bausparkassen." These institutions are designed to collect savings deposits on a regular basis at a low, below-market rate and recycle the low rate on their funding into low rates on their loans.

In the simplest version of such a system, there is no net gain to depositors, who must forego enough interest on average during the saving part of the cycle (e.g., receiving 3% on their savings) to fund the below-market rate on a loan later (e.g., paying 6% on their loan). In principle, if individuals valued such an arrangement, either because of the low fixed rate on such loans or because contracting to deposit savings regularly was desirable (perhaps because it is easier to save or because it provides the bank the evidence that they are reliable borrowers), the public would participate in such a system set up by a regular bank. This has been tried in several countries, but generally such simple arrangements are not popular.[1] Why? It appears that people do not value these advantages enough to give up the flexibility of deciding when and how much to save and when to ask for a loan.

The Bauspar system moves beyond this to introduce a significant government subsidy to "sweeten the pot" and make it attractive for savers to participate. The extra payments go towards making the return on savings equal to or even better than other forms of savings, so that people will want to participate even if they are not sure that they will want a loan after their savings period. If it is the case that the return on savings is just equal to the alternative market return (e.g., on bank deposits), people are still attracted because the

[1] For example, a very talented housing finance institution in India, HDFC, devoted extensive efforts to implementing such a system, with little success.

system conveys a significant subsidy to those who actually do borrow at the below market rate.[2]

Why should a government provide such a subsidy? There are several public benefits claimed for Bauspar systems. The simplest are the usual arguments for subsidies for housing in general. The major added advantage is that, in order to receive the below-market loan (which is the major source of subsidy to the participant), the beneficiary must complete a program of savings that arguably shows that he or she has a reliable character and, even more importantly, is a good credit risk.[3]

An additional argument is made to support the provision of sufficient subsidy so that the return on savings is even better than that available from more conventional savings vehicles. A savings system where the subsidy only becomes available at the end of the savings cycle produces a pool of savings that is very stable in the short run; few will find it worthwhile not to finish the savings program once started. In theory, it is very desirable to fund long-term loans for housing out of such stable pools of resources. Although the need for artificially constructing such pools through such subsidies is debatable in the modern financial system (there are many more efficient alternatives), this argument is still considered to be a significant advantage of the system.

Finally, it is claimed that by tying a subsidized loan to the completion of a savings program, people are more likely to save and those that save will save more. In other words, that Bauspar systems expand the supply of domestic household savings.

It is worthwhile noting that there are somewhat different visions of the role of a Bauspar system in Germany and Austria. In Germany, the government bonuses are relatively small and just sufficient to compensate those savers who do not eventually borrow for their lost opportunities of getting a market rate elsewhere. The focus of the program is on encouraging good savings (and loan repayment) habits and on delivering a small below-market, but relatively short-term, loan at the end of the savings period.

In Austria, the system is more oriented towards creating a large pool of long-term funds for use in funding large below-market loans with relatively long terms for housing. To accomplish this, the subsidies to savers are set such that the return is higher than on other options, to compensate savers for the loss of liquidity from saving in the Bauspar system.

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[2] In theory, many people would participate even if the effective return on savings was not as great as in a bank, simply because they want to get the low rate loan. However, then almost all savers would want to take a loan as soon as they completed their contract, and the Bauspar would more easily run out of enough low-rate funds to offer such loans.

[3] This was a major rationale in Germanic countries traditionally, but it has been diluted as more of Bauspar loans have been made before completion of the savings period and as personal credit histories have become more available.

Such a system is more expensive to the government, but also conveys larger subsidies to housing, especially by permitting very long terms on the Bauspar loans

Slovakia and the Czech Republic were the first CE countries to adopt Bauspar systems, early in their transition programs, followed much later (due to longer debate) by Hungary. It is not a coincidence that these countries took this step. There are very large potential commercial rewards possible from such systems, especially in the early years when no participants qualify for a low-rate loan[4] and yet the Bauspars can invest the low-cost funds at market rates. Moreover, all three countries have had high market interest rates relative to the Bauspar's low interest rates due on savings, making the potential profits that much larger. This situation was a great attraction to those with the potential to profit from it and policymakers in all of the countries report that strong lobbying efforts of German and Austrian Bauspar interests were decisive in causing the creation of a Bauspar system in their country.

However, there are important differences in the specifics of the systems across countries. These differences will be examined later.

Key Parameters of Bauspar Systems

All Bauspar systems share certain key variables that must be chosen at the time of initiation and modified over time to keep the system running properly.

As noted in the above discussion, one such parameter is the amount of subsidy that is conveyed to the participants. This depends on several separate parameters, including (1) the rate paid in savings and the loans, (2) the percentage bonus on savings, (3) the minimum number of years until the bonus and savings can be withdrawn, and (4) the presence of a requirement that the savings and/or loan be spent on a housing-related purpose. But overarching all of these considerations is what the public's alternatives are with respect to ordinary savings and borrowing opportunities. The subsidy from the point of view of the public is what they get extra on their savings and what they save on their loan payments. (The subsidy from the point of view of the government includes also the extra cost and profits of the Bauspars as a conduit for the subsidies to the public.)

In this regard, the subsidy environment in the CE countries is very different from that in Germany and Austria. Interest rates on alternative savings vehicles in those countries are nearly as low as those paid by the Bauspars and similarly the cost of borrowing from a bank is also nearly as low as borrowing from a Bauspar. Moreover, those differences are not likely to change radically. Thus, only a relatively small subsidy is required to coax

[4] It is sometimes noted that the Bauspars are willing to make loans well before the completion of the contracted savings period ("bridge" loans that are repaid at the conclusion of the savings period), but the effective return on the Bauspars funds is the normal market rate.

people into saving, and many more people are likely to forego a loan, so the liquidity situation is easier to manage.

In all of the CE countries, the Bauspar interests have imported the standards for savings and loan interest rates that have traditionally applied in their home countries.[5] Since alternative savings rates are so much higher in the CE (10-20 percent), there is a need for a much larger bonus rate. On the other hand, once the effective return on savings is matched to the market rate, the potential subsidy conveyed by taking out a loan at only 6 percent looks far more attractive to participants. (In fact, in countries such as Hungary, where market rates on bank deposits are 15-18 percent, it will be very tempting to all participants to take out a loan (assuming that they can come up with a plausible housing purpose for it).

The interest rate structures in these countries are also much more uncertain in the future. The implication is that there may be some extra concerns about balancing out the flow of savers and borrowers. If interest rates drop, and the bonus does not drop, many more will participate in order to get the extra return on their savings, and fewer will borrow at 6 percent. If interest rates rise, then savings will drop off and borrowing will rise. Essentially, the net return on savings and net savings on a loan are locked in at the time the contract is started, and there is an extra level of uncertainty about how these will compare with market alternatives. One way to deal with this is to give an extra big bonus to make it more likely that the system will never fall short of funding. Another is to restrict what the Bauspars can promise with respect to size and term of loan and also how much they can take out in the form of dividends in advance of the maturation of the system.[6]

Translating the bonus into a subsidy is a bit complicated. The bonus is a one-off extra return on the savings during the previous 12 months which can not be tapped into for a certain amount of time after receipt. For example, what is the subsidy element in a 30 percent bonus paid in January 1999 based on savings over 12 months in 1998? If it could be withdrawn in January 1999, the total return would be equal to about 60 percent. Why? Because the average amount of savings in the account during the year would be only half of the amount in it at the end of the year, which is the amount on which the bonus is based. However, if those savings get no further bonus (but additional savings do), and if no further interest is paid on those first-year savings, the return on those savings drops sharply, to 18.5 percent, if they can only be withdrawn after 24 months, in January 2000. More realistically, if an equal additional amount is saved the second year and earns a 30 percent bonus, and if the bonuses, the savings and a Bauspar return of 3 percent can be

[5] While the norm in all countries is for savings to earn 3 percent and loans to cost 6 percent, for competitive reasons some of the Bauspars in the Czech Republic (with 6 banks) offer higher amounts on the savings.

[6] Hungary, with its high and volatile interest rates, has adopted this approach, while the Czech Republic and Slovakia have adopted the first approach.

taken out after the second year (as under current Polish law), the effective return overall is about 29 percent.[7]

It is important to recognize that those who do not plan to take a loan have a strong incentive to remove their funds as soon as allowed to keep the bonuses. Every month that people leave funds in their account earning 3 percent is very costly. They can continue to make additional deposits and earn more bonuses, but it makes sense for them to withdraw the first set of savings and put them in a bank while steadily transferring them back into a new Bauspar account.

This calculation of the effective return on savings in a Bauspar requires a sophisticated program and is certainly beyond the ability of most people, but the logic is clear and it is the job of the agents of the Bauspar to communicate just how attractive the net result is. Judging from the experience in the other countries, the public is quite sensitive to what they perceive to be the net gain from participation. It becomes a burden on the policymakers and budget estimators to set these key parameters, i.e., the bonus and the minimum time to withdrawal, and try to anticipate the course of inflation and public reaction.[8]

The other key determinate of the popularity of the system is the conditions under which the bonuses can be withdrawn and loans taken out. As will be seen in subsequent chapters, this has varied across the countries at earlier times, but so far there is little hard evidence how much it matters whether a housing purpose is required. What is clear is that in all three countries the rate on a Bauspar loan will be much less than on a market loan and this will make it attractive to do what is required to access a low-rate loan.

Experience in Central Europe

Table 1 summarizes the parameters of the Bauspar systems in the Czech Republic, Hungary, and Slovakia. It also reports on their experiences with respect to participation, savings, loans, and cost. The bonus and return data is for 1998, but the data on cost and participation is through 1997. More details on each system and on the history of their experiences are reported in the chapters that follow.

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[7] This is why Hungary does not allow withdrawal of the bonuses until 4 years after start of the contract.

[8] It is sometimes stated that a short minimum saving period will reduce the budget cost. This is incorrect. First, a short saving period means a higher return on savings, thus making Bauspar accounts more attractive and costly to the budget. Second, it just means that the life of accounts is shorter and they must be closed and the funds recycled into another one earlier.

Table 1
Operation of Bauspar Systems in Central Europe

	CZECH REPUBLIC	HUNGARY	SLOVAKIA
Year of Initiation	1993	1997	1992
1998			
Percent Bonus	25 %	30 %	30 %[9]
Minimum Years to Withdrawal	5	4	6
Housing Purpose?			
For Bonus	None	Yes, until 8 years	Yes
For Loan	Yes	Yes	Yes
Savings for Max. Bonus	USD 560/Year	USD 560/Year	USD 570/Year
Max. Savings and Loan for Couple	USD 15,000	USD 12,000	USD 15,000
Effective Rate on Savings	13 % tax-free	16 % tax-free[10]	11 % tax free[11]
Market Rate on Savings	10-12 % taxable	14-16 % tax-free	10-12 % taxable
Rate On Loans	6 % non-deductible	6 % non-deductible	6 % non-deductible
Market Rate on Loans	14-15 % tax deductible	27 % partially deductible	14 % non-deductible
1997			
Net Contracts	1,968,000	290,000	907,000
Net Savings (Mil. USD)	1,863	50	853
Net Loans (Mil. USD)[12]	285		65
# of Loans	81,800	0	21,000
State Premiums (Mil. USD)	172	19	100
Premiums/State Budget	0.8 %	0.0 %	1.4 %
Premiums/Housing Budget[13]	59 %	13 %	46 %

It is notable that certain aspects of the programs are very similar across countries. All three countries offer the maximum amount of bonus for savings of about USD 560 per year. If both partners in a couple start optimal contracts, they will be able to take out in savings and in loan an amount (at current exchange rates) around USD 12,000-15,000 after 4-6 years (actually, these USD amounts will be substantially less in 4-6 years because of future inflation). Another similarity is that, in general, currently the programs require that bonuses, as well as loans, be spent for housing purposes (this was not the case at earlier times).

[9] Bonus had been 40 % prior to 1997.
[10] Return was 18 percent for contracts started in 1997.
[11] Return was 13 percent prior to 1997.
[12] These include only loans to customers, not loans to other parties.
[13] This item is for 1998. The "housing budget" used here includes only those expenditures designed to support current activity in the housing market. It excludes expenditures on "old loans", housing allowances, and similar items. See individual chapters for more detail.

In all three countries, the programs started up very strongly. This primarily reflects the very large incentives for the Bauspar banks to move quickly and strongly to acquire clients, since these clients will then be committed to saving with that bank for 4-6 years, and most of those savings, at a cost of 3 percent in interest, will then be available to be invested in government bonds at full market rate. Thus, all three countries experienced large marketing campaigns that were unprecedented for a financial product.

Growth has continued at a strong rate in the Czech Republic, with 2.2 million contracts expected to be outstanding in 1998, or about 40 percent of the number of persons between the ages of 20 and 60. This may be a short-term peak for this system, since in 1999, many of the earliest contracts can be closed and loans taken. There have also been a growing number of bridge loans taken in the Czech Republic as the housing market has recovered and more contracts approach maturity. As of the end of 1997, 82,000 loans had been made, at an average of USD 3,500 each. However, this was still only 4.1 percent of the number of contracts.

Slovakia has experienced a slowdown in growth in net contracts, and seems to be peaking at less than 1 million. This is because (1) many of the early contracts were closed in response to the option of cashing out early and keeping the bonus and (2) the bonuses were reduced in 1997 and a housing purpose was required for new contracts to get the bonus, even after 6 years. Moreover, relatively few loans were taken out through 1997. This was because the private housing market did not recover until recently and most of the early contracts were not held until completion. On the other hand, Slovakia has experienced the greatest burden on its budget, peaking at 1.4 percent in 1997. This was because of its extraordinarily large bonus of 40 percent until 1997.

Hungary has had the unusual experience of a sharp slowdown in growth in the second year of the system. This was because of a provision in the law that cut the first year bonus from 40 percent for contracts started in 1997 to 30 percent for later contracts, because of the expected decline in market interest rates.[14] The result was that there were many more contracts than might be expected in 1997, since most people who might want to start a contract in the first two years faced a large incentive to starting it in 1997.

Both the Czech Republic and Slovakia have set their bonus levels and minimum periods to withdrawal of bonuses such that the after-tax return on the Bauspar accounts is significantly higher than on ordinary bank accounts (this gap was even more pronounced at the lower market rates in 1993-96). This has meant that a major share of household savings has been switched towards the Bauspar system. In Slovakia, over 20 percent of total time and savings deposits of households are now held by the two Bauspars.

[14] This feature was the result of a compromise between the Bauspar interest, who wanted 40 percent permanently, and the Ministry of Finance.

In Hungary, the government has tried to set the parameters so that those who can make good use of a low-rate housing loan will participate, yet not draw a major share of household savings into the system. This process may yet be undermined if the bonus rate stays at 30 percent while the market interest rates decline.

Conversations with policymakers in the Czech Republic and Slovakia suggests that the system has been a disappointment in terms of real effect on the housing market relative to the outlay of budget resources, at least in the period until the low rate loans become commonly available. Notably, both the Czech Republic and Slovakia created programs of more direct subsidy of new construction while waiting for the effect from their Bauspar systems. However, these new programs have been limited by the large size of commitments to paying for the Bauspar systems.

The most interesting result of these concerns was in Slovakia, the country which has invested the most resources into their system (an average of 1 percent of the state budget from 1994-97) with almost no real impact on housing. Unique to Slovakia, the government reserved to itself the ability to reset the bonus and other parameters by regulation or in the annual budget legislation. Because of this, the Bauspars have to negotiate directly with the government to avoid changes in the subsidies and other aspects of their activities.

A result has been an *ex post* extrication of subsidies through the successful "persuasion" by the government for the purchase by the Bauspars of bonds issued by the State Housing Fund at a below-market rate. Over SK.. 1 billion in such bonds have been bought by the Bauspars, at a rate of 10 percent, significantly less than the rates of 15 percent or more on conventional government debt. These funds are then channeled into immediate low rate loans by the State Housing Fund that are unconnected with any prior savings (and also allow the Bauspars to claim that they are supporting housing construction.)[15] Despite this, the government has significantly reduced the attractiveness of Bauspar savings in order to restrain the burden on the budget.

There were four goals of Bauspar systems noted above, namely (1) subsidize housing, (2) increase savings, (3) indicate credit-worthiness, and (4) create a pool of stable funding. Is there any evidence that the two mature systems have had these effects? The simple fact is that it is still too early to answer most of this question, because there are only now enough contracts maturing that might allow a significant number of people to transform them into loans and actually deliver subsidies to housing.[16] More analysis will have to be done later to determine how much subsidy is being delivered to housing (goal #1).

[15] The concern about this disappointment with the Bauspar program has also prompted the Bauspars to offer of bridge loans at slightly below-market rates and to pursue a publicity effort claim that much of the subsidy has flowed into housing in some way or another.

[16] Bauspars sometimes claim that the bonuses are subsidies to housing. Since the purpose of the bonus is primarily to bring the rate of return on savings up to market levels, there is very little actually added to the housing resources of a saver who simply gets a bonus and not a loan.

There are reasons to expect that goals (2) and (3) will not be realized. In Central Europe, anyone who is expecting to buy a house must already have significant savings or access to help from relatives. At current house prices and market interest rates, there is no prospect that a deposit of only 10-20 percent of the house cost will be sufficient, even with a Bauspar loan supplementing other borrowing. Thus, would-be home buyers will generally be in a position to simply shift existing funds steadily into their Bauspar account in order to earn the higher rate of return, as well as the subsidy conveyed by the 6 percent loan. If this is the case, participants may neither end up saving any extra nor even prove much about whether they will be able to continue to make steady payments on their Bauspar loan, much less an additional regular bank loan, after they have sunk all of their available cash into their house purchase.[17]

Finally, there is the often-stated need to create a pool of long-term stable funding for housing finance (goal #4). This has clearly been of no value so far, simply because the activity levels of housing finance in all three countries have been so low that the normal deposit base of commercial banks has been more than adequate. Similarly, the notion that the Bauspars would then be a source of funding of medium-term mortgage bonds has also been irrelevant, because the lack of need for additional funds has meant low issuance of mortgage bonds. This may change in the future, but most of the countries are creating private pension fund systems that also will provide a strong supply of funds for medium-term mortgage bonds in the near future.

Ironically, the way that the Bauspar systems in the other countries have been started, with large advantages to participating, has actually introduced an element of instability where none existed previously. A huge number of people rapidly built up rights to subsidized loans, with no certainty as to how many would follow in their footsteps to support those loans, especially if hard-pressed government wanted to cut back on the huge subsidies committed to support these systems. In retrospect, many policymakers would have preferred to start off more slowly. Hungary is attempting to do this, and Slovakia is trying to shrink its commitment to the Bauspar system.

What is certain is that the maturation of the Bauspar systems will greatly expand the amount of borrowing for "housing purposes." With market interest rates 6-12 percent higher than the Bauspar rates, there will be three reasons to expect additional borrowing. First, some households that would have some real housing purpose that they would have pursued anyway will borrow at that rate to finance it, rather than dip into savings or borrow from a bank. Evidence that this is in fact a large pool comes from Hungary, where a significant subsidy (but smaller than the Bauspar subsidy) to small loans for renovation

[17] It may be possible to carefully analyze the financial flows in these countries to consider this proposition, but such work has not been done. It is notable that observers in the three countries felt that most savings going into the Bauspars had been diverted from other forms of saving.

existed until 1994, and supported a huge market for loans by the former state savings bank (70,000 in 1993). However, once the subsidy was eliminated in 1994, loan volume shrank by more than 90 percent (5,000 in 1997). The reverse can be expected as even a larger subsidy becomes available and is useable on even more items.

Second, there will be at least some borrowers who actually are able to pursue renovation or home purchase activities that they otherwise would not have been able to afford with cash or a market-rate loan. These represent the response that presumably constitutes one of the major public benefits from the Bauspar system. There is no way to know for certain how many they are, but fragmentary evidence suggests that most of the lending is going to finance activities that would have been financed in some other way.[18]

Third, there will be those who entered into a contract because of the higher rate of return on savings and now find it very hard to pass up the opportunity to also borrow at 6 percent and reinvest it in a bank at 12-18 percent (or in new Bauspar account for an even higher return). Based on the background of skills learned by Central Europeans during years of "working the system" in order to survive, many such persons should be able to find some way to tap into this profitable opportunity.[19]

On the Inefficiency and Politics of Bauspar Systems

It may be worthwhile examining a point that is often overlooked in the discussion of Bauspar systems. There are many ways of creating and distributing subsidies to housing, including direct grants, low-rate government loans, interest rate subsidies, tax subsidies, and so on. All of these have their strengths and weaknesses, and in fact all are inefficient in the sense that the direct costs are greater than the direct benefits. Within this group, however, it can be argued that the Bauspar system is one of the most inefficient.

The concept of efficiency referred to here is the ratio of the public benefits to the public costs. This encompasses all the value of social goals that are being met, including the four goals mentioned above, relative to the budgetary cost. Housing programs which have relatively little in the way of social benefits (e.g., little impact on changing housing decisions, subsidies flowing to households who do not need them) and also high administrative costs (either directly through a bureaucracy or through subsidies to a private entities) would be considered to be highly inefficient.

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[18] One piece of evidence is the experience in Hungary, where there is no evidence that actual renovation activity declined when the subsidy to renovation finance was removed. The experience in the Czech Republic also suggests this view, at least for housing construction, because over 60,000 Bauspar loans were made in 1997 and, despite this, private housing starts rose by less than 10,000, and most of that increase could have been expected anyway.

[19] One of the simplest is to find a close relative who is planning to incur expenditures for a housing purpose and pass along the borrowing rights to them with understandings about the final destination of the funds.

In the Bauspar system, the flow of the subsidy is very indirect and untargeted, and involves large administrative costs. There is no limitation on the income or assets of participants, although the size of the potential subsidy is so small relative to the assets of truly rich households that they may not bother to participate. The subsidy is delivered via a mechanism that subsidizes the payment of interest on savings. This allows the Bauspar to then offer a low rate on a loan, but the actual determination of who gets this eventual subsidy and what if any impact it has on actual additional housing consumption is completely out of the hands of the government. Moreover, the whole system involves large costs to administer (including commissions to agents selling contracts, as well as for office, management and other overheads).

Finally, even after these costs, there are extraordinary profit opportunities (and some risks) to shareholders, who receive the benefit of an arrangement that gives them access to funds at 3 percent and the unfettered right to invest much of them (all of them until the system matures) at a full market rate and keep the difference (as well as collect a 3 percent margin on their housing loans). The ultimate profitability of a Bauspar depends on how well it keeps new accounts being opened relative to those taking out loans. In theory, it could run into a period of losses and this is more likely in Central Europe. But it is notable that the largest Bauspar in Slovakia recorded profits, including amounts labeled for provisions or reserves, of USD 53 million, equal to a 180 percent return on shareholder equity.

In contrast, programs such as the interest-free or low-interest loan programs (started up in the Czech Republic and Slovakia after the Bauspar systems began) provide assistance that is delivered through low-cost arrangements with private lenders, and are targeted to moderate income households building new houses. While such programs are not necessarily the most efficient (they may not help those with the greatest housing needs and many units subsidized would have been built otherwise), the impact on actual construction activity is apparently considered to be greater than any impact so far by the Bauspars, at a much lower cost.[20] Germany itself focuses most of its assistance to young homebuyers on a lump-sum subsidy rather than on the Bauspar system.

This discussion may raise the question as to why Bauspar systems have been adapted in these three CE countries, if other approaches to assisting housing are more efficient. To this observer, the answer lies in its unique attractiveness to most of the relevant parties in the political decision making process. All the savers feel like they are getting a gift of extra interest for being "virtuous" about their saving. Most homeowners, and not just poor ones or those building new houses, feel that they are getting some help with the burden of buying or maintaining their home. The public feels in general that the housing sector

[20] The Czech program provided zero-rate loans of USD 6,250 to 3,000 households for 14 percent of the cost of the Bauspar system in 1998. From another viewpoint, 21,000 household could have received such loans for the same cost as the Bauspars.

is being helped. The banks which start up Bauspar banks are being given an opportunity to make extra profits and also chip away at the dominance of the former state savings bank in the retail sector. And the political establishment is getting heavy lobbying from many self-interested parties.

Practically the only opposition comes from government budget makers, who see more graphically the opportunity cost in terms of foregone alternative initiatives in housing or other sectors.[21] Moreover, they are more aware that the government will have very little short-run control over the expenditures of such system and that there is a political hazard in ever trying to reduce the system later, because of the fear that thousands, or even millions, of savers will then not be able to get the low-rate loan that they thought they were promised.

[21] This is not to say that many countries outside of Central Europe do not indulge in inefficient housing subsidy schemes for the same reasons. The prime example is the U.S., where the deduction for mortgage interest is universally condemned by economists, the U.S. Treasury, and most housing policy analysts, but enshrined in the hearts of the public and lobbyists.

THE CURRENT OPERATION OF THE BAUSPAR SYSTEM IN THE CZECH REPUBLIC

Population: 10.3 million (1995)
GDP: CZK 1.6 trillion (1997)
State Budget: CZK 498 billion (1997)
Exchange rate: CZK 32/USD 1.0 (1997)

Description

The experience with the Bauspar system in the Czech Republic can be summarized as follows:[22]

Main Act:	25 February 1993, first operations in September 1993
Regulation:	Ministry of Regional Development regulates and supervises the payment of premiums; Central Bank regulates/supervises the Bauspars, but follows conventional bank regulations, with no additional regulation imposed on liquidity management.
Amount Yearly Premium:	25% of savings, up to CZK 4500. Annual optimal savings is CZK 18,000, or twice the average monthly wage in 1993 (but only 150% in 1998)
Minimum Saving Period:	5 Years to get housing contractual loan (usually at 6%) if 50% of contracted sum is saved. But possible to get an interim loan at a higher rate after 2 years. Saving for 5 years required to cash the premium; not required to use for housing. Loan only for housing purposes; to be demonstrated by invoices (initial provisions allowed for loan for non-housing purposes).
Main housing use:	Mostly privatization of municipal flats, repairs and renovations, and purchase of existing flats.

The Bauspar system has grown quickly in the Czech Republic. Four institutions were able to get into operation in the first year, and two more in 1994. The very first, the Czecho-Moravian Bauspar, has remained in the lead of the other five since then. All six institutions

[22] Based on research reported by Loïc Chiquier.

have strong minority participation by German or Austrian Bausparkassen, with majority ownership resting with a Czech universal bank

Table 2 gives the cumulative results of the system.

Table 2
Activities of Bauspar Banks in the Czech Republic

	1993	1994	1995	1996	1997	1998 (est.)
Net Contracts (in thousands)	206.0	651.4	1,104.9	1,560.1	1,967.8	2,200
Net Savings (Bil. CZK)	1.1	6.4	16.3	34.5	59.6	85
Net Loans (Bil. CZK)	0. 0	0.0	0.2	2.2	9.1	20
# of Loans (in thousands)	0	0	0.9	17.9	81.8	180.0
State Premiums (Bil. CZK)	0.0	0.3	1.1	2.3	3.8	5.5
Premiums/State Budget (%)	0.0	0.1	0.3	0.5	0.8	1.0

Other relevant aspects of the system include:

- the interest and premium on savings are exempt from taxation;
- premiums are paid into the account within one or two months after the end of the "contract year" (the 12 month cycle since start of the account);
- the interest paid on loans made for new construction is not tax deductible (in contrast to interest on such loans by mortgage banks);
- accounts can be tied to issuance of a market-rate housing loan immediately (by the parent commercial bank), repayable by a bridge loan from the Bauspar after 2 years; and
- the parameters of the state premium are embedded in law, and Parliament must act to reduce or increase it.

As can be seen from Table 2, the Bauspars have been very successful in drawing in savings and are starting to make low-rate loans. Their success has partly been due to the extensive marketing that has been done on their behalf and partly due to the attractiveness of the financial return on savings, independent of the value of the housing loan. Over the minimum 5 year savings period, the 25 % premium on the annual contribution, on top of a 3-4 % return on accrued savings, will yield an after-tax return of about 12 %. This return has been significantly more on an after-tax basis than most alternatives. Moreover, the Bauspars are making it a practice to give savers a 1.5 percent bonus to the basic interest rate if the savers decline their right to a 6 percent loan at the completion of their 5 year saving period. This provides an after-tax yield of over 13 percent to the "good brothers".[23]

Thus, the Bauspar system in the Czech Republic shares with Austria an attraction to most all households as a savings vehicle. In 1992-1996, tax-free government bonds yielded 11 percent. Even after interest rates increased in 1997-98, the before-tax yield on government debt of 15 percent translated into an after-tax yield of only 11.25 at the standard tax rate of 25 percent on interest. Time deposits in banks have paid only 10-12 percent before tax during this period, so that the after tax yield has been 7.5-9.0 percent. When these are contrasted with the 13 percent yield on savings in a Bauspar, it is easy to understand their success. Total savings in the Bauspar system is now approaching CZK 100 billion or over 12 percent of household deposits in the banking system.

The maximum amount of subsidy is achieved by saving at a rate of CZK 18,000 a year for 5 years. With interest and premium, this would provide total savings of about CZK 120,000 after 5 years. Matched with a loan of the same size and with a second savings amount and loan for a spouse, a couple can acquire a total of almost CZK 500,000 towards a housing investment. This is a relatively large amount, about USD 15,000 currently, more than 50% of the cost of a modest existing flat, but only a quarter of the cost of a more substantial flat or a family house.

However, the average amount of saving actually done per contract is only about half of this maximum amount (but growing over time). It is commonly observed that the Czech Bauspar system will be useful to existing homeowners and flat residents for purposes of renovations, and only a small minority will use it to finance a home purchase. Some large portion of savers (40-70 percent) are expected to be simply happy to receive the higher after-tax return on their savings and not take out a loan.[24]

The 2 million savings accounts at the Bauspars will benefit from CZK 5.5 billion in state premiums in 1998. At the end of 1997, the Bauspar had about 82,000 loans outstanding for a total of about CZK 9 billion, for an average loan of CZK 110,000 or about USD 3,500 each. However, the number of loans is expected to increase rapidly as many more of the savers reach the 5 year mark when a loan can be obtained. Only 206,000 contracts were opened through December 1993, and an average of 500,000 a year since then, so the next several years should see a significant upsurge in loans. (One observer noted an expectation of 100,000 loans made in 1998.)

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[23] Each additional "good brother" who saves but does not take a loan is quite valuable to a Bauspar, since they are paying only 3 percent on the savings, which they can lend out at around 15 percent. Thus, apparently the Bauspar also offer other inducements, such as free credit cards, in addition to savings bonuses.

[24] This may change if interest rates on deposits stay as high as they are currently, since the spread between them and 6 percent is much larger than it was in 1993 and thus the opportunity to profit by investing a loan is larger.

There is some evidence that the Bauspars have encouraged additional investment in housing. In principle, all of these loans have been for "housing purposes", a term which includes everything from painting a house to paying off an existing loan to buying an existing house or building a new house, and most were probably for repair or purchase of an existing house. Although it is probable that relatively few loans were for new housing, it is likely that many of them were used for some housing purpose that needed additional financing. This is because most, if not all, of the loans originated in 1997 would have been bridge loans and would have had an effective rate approaching that on market rate loans, so that the borrower is less likely to take out the loan without really needing it.[25]

A special government loan program for new housing became available after 1 July 1997 and most participants have used it with a Bauspar loan. The two subsidies together can make a large difference in the affordability of a new house. However, overall, the upward trend in housing starts had been in place since 1993 and it has not accelerated notably as more Bauspar loans are being made.

There are two other major effects in addition to whatever the effect on new construction is. First, many small savers have received a windfall in terms of a higher return than otherwise on their savings. This may have had some effect on promoting overall savings, but it is debatable if that is desirable if that extra savings is forced into the housing finance sector. Secondly, many people who would have undertaken a home-repair or improvement without a loan will take a loan, if only because they can reinvest their available cash savings in a bank account (or a new Bauspar account) at a return that is higher than the 6 percent rate on the loan.[26] In fact, some may actually then spend what they would have spent on the project instead on something else. This would mean that the net debt position of the household sector could actually increase (after all, this would make sense if one can borrow at a - 4.0 percent real rate of interest), causing smaller net savings.

Other Housing Subsidies in the Czech Republic

The Czech Republic has several efforts to support the housing market, particularly the construction of new housing. These are listed in Table 2, along with the amounts budgeted for 1998. However, more than half of the support going towards the current development of the housing sector is for the Bauspars.

[25] It is impossible to judge the true need for the low-rate loan. For example, households which already had the ability to buy or build a house anyway and did so in 1997 will want to take a Bauspar loan at that time, even a bridge loan, because they will not be eligible to do so after they complete the purchase.

[26] Another argument for the creation of Bauspars is that they would provide a source of long-term funding for mortgage banks. This has not proven true so far, because the mortgage banks have not issued many bonds. Moreover, the more efficient way of developing such a pool of long-term funds is to encourage private pension funds which can invest in long-term debt instruments from throughout the economy.

Table 3
Subsidies to the Current Market for Housing Finance in the Czech Republic, 1998

Program	Budgeted Amount (CZK Millions)	Number of Units	Amount per Unit (CZK)	Targeting
Municipal Rentals	2,928	6,500	370,000	New, modest size, low-rent
Bauspars	5,500	2,000,000 contracts	2,750/contract	All Housing Related
Mortgage 4% Subsidy	150	3,300	43,000	New Housing
Interest-Free Loan	750	3,750	200,000	New Housing, Middle-income
Retirement Houses	670	700	100,000	New Units in Retirement Houses
Tax Deduction of Loan Interest			????	
Total	9,998 (1.8% of budget)			

The largest is the direct subsidy being paid to local governments to support the construction of additional **municipal rental units**. It provides about one-third of the cost of a modest new flat. This program has been in place since 1995 and has already been responsible for financing commitments for 18,700 units through 1997. The unusual part of the program is that would-be tenants pay about one-third of the unit's cost in the form of "advance rents" and thereafter pay only maintenance costs, with the expectation of taking ownership after 20 years.

It is well-known that the Czech Republic offers a **4 percent subsidy** over 20 years to those who take out a loan from a mortgage bank to buy a new house. What is not so well-known is that there have been so few mortgage loans that the cost of this subsidy is practically negligible, only CZK 150 million in 1998.

Very importantly, the government introduced a new subsidy in July 1997 that provides a CZK 200,000 **interest-free "loan"** for a new house. It is essentially a grant, since no payments are due for the first ten years and it is expected to not be counted as an indebtedness when calculating the amount that someone can borrow from a regular or

Bauspar bank. It has been very popular, and the funding for 1998 was used up by June. There is a limit on income for it, but one that is not so low and often easily circumvented.

There is some discussion about possibly imposing limits with respect to the price of the house or income for some of these programs.

As in the other countries, the official "housing budget" contains significant amounts for programs that do not directly support the general housing sector currently. The largest of these is CZK 2.2 billion for assistance with energy costs and municipal rents, essentially a housing allowance. Another CZK 1.8 billion goes towards the burden of old low-rate loans. Modernization, energy efficiency, and other smaller programs receive almost CZK 1 billion, for a grand total of CZK 15.1 billion, or about 2.7 percent of the budget. (Another CZK 2.8 billion is included in a sub-category of flood recovery programs.)

THE CURRENT OPERATION OF THE BAUSPAR SYSTEM IN HUNGARY

Population: 10.3 million (1994)
GDP: HUF 8.6 trillion (1997)
State Budget: HUF 2.7 trillion (1997)
Exchange rate: HUF 190/USD 1.0 (1997)

Description

Hungary was the last of the three countries to enact Bauspar legislation. Thus, the scheme just started up in 1997.

The Hungarian Bauspar system can be summarized as follows:

Main Act:	November 1996, first operations in May 1997
Regulation:	Ministry of Finance regulates and supervises the payment of premiums; Central Bank and the Monetary and Capital Market Supervisory Board regulates/supervises the Bauspars, and follows extensive special regulations and restrictions, modeled after ones in Germany but modified, especially on provisions and liquidity management.
Yearly Premium:	In 1997, 40 % of savings, up to HUF 36,000 and annual optimal savings was HUF 90,000. In 1998, 30 % of savings, with the same maximum; optimal savings is HUF 120,000 or about 2.5 times the average monthly wage.
Minimum Saving Period:	4 years to get housing contractual loan (usually at 6%) if 50% of contracted sum is saved. But possible to get an interim loan at a higher rate after 2 years. Saving for 8 years required to cash the premium without use for housing (also get 0.5 percent interest premium). Housing purposes of loan to be demonstrated by invoices.
Main housing use:	Mostly repairs, renovations and some purchases of existing flats.

The Bauspar system has grown quickly in Hungary. Three institutions were able to get into operations in the first year, and one more is starting in 1998. Notably, the largest single institution, the one sponsored by the former state savings bank, OTP, has no minority participation by a German or Austrian Bausparkasse.

Table 4 gives the cumulative results of the system.

Table 4
Activities of Bauspar Banks in Hungary

	1997	1998 (est.)
New Contracts	300,000	100,000
Net Contracts	290,000	350,000
Net Savings (Bil. HUF)	10	30
Net Loans (Bil. HUF)	0	0
State Premiums (Bil. HUF)	0	4.0
Premiums/State Budget (%)	0	0.1

Other relevant aspects of the system include:

- the interest and premium on savings are exempt from taxation (but so is interest on regular deposits);
- premiums are paid into the account two months after the end of the "contract year" (the 12 month cycle since start of the account);
- the interest paid on the loans is not tax deductible (in contrast to a limited deduction for loan repayments on ordinary loans for new houses);
- accounts can be tied to issuance of a market-rate housing loan immediately (by the parent commercial bank), repayable by a bridge loan from the Bauspar after 2 years; and
- the parameters of the state premium are embedded in law, and Parliament must act to reduce or increase it.

As can be seen from Table 4, the Bauspars were very successful in drawing in savers in the first year. Their success has partly been due to their extensive marketing efforts and partly due to the feature of the law that provided for a drop in the premium after the first year (a compromise with the Bauspar interests in the Parliament and due to the expected decline in inflation). This implied that, if one were thinking of starting a Bauspar account over the next 2-3 years, the optimal time would be in 1997.[27]

The maximum amount of subsidy was achieved by saving at a rate of HUF 90,000 for the year starting in 1997, followed by HUF 120,000 the next 3 years. With interest and premium, this would provide total savings of about HUF 630,000 after 4 years. Matched with a loan of about same size and with a second savings amount and loan for a spouse, a couple can acquire a total of about HUF 2.5 million towards a housing investment. This is a not a small amount, about USD 13,000 at the 1997 exchange rate but expected to be only USD 8,000 at the exchange rate likely after 3 more years of inflation. This would be about 30 percent of the cost of a modest existing flat. More so than in the other countries,

[27] As a result, new contracts have fallen off sharply in 1998. Another cause of this decline was the inauguration in 1998 of private pension plans, that have become the focus of financial marketing efforts.

the Bauspar system in Hungary is designed to finance major renovation and to primarily supplement the financing of an existing flat or a family house.[28]

For those starting before 1 January 98 and saving over the minimum 4 year savings period, the scheduled bonuses on the annual contribution, on top of a 3 percent return on accrued savings, will yield a compounded annual return of about 18 percent. Contracts started in 1998 will yield a return of only 16 percent. Both returns are only a bit higher than that on 1-year bank deposits at the time, but the rate on bank deposits are expected to decline over the next 4 years (long-term interest rates are lower than short-term rates). Thus, the Bauspar account offers a significantly better return over the full period, balanced by a loss of liquidity. However, the size of the extra return in Hungary is not as large as in the other countries.

Moreover, Hungary has a provision that those who do not have a housing purpose for their savings must wait for 8 years to withdraw their funds. In principle, this means that some savers should hesitate to take a contract just for the higher return on savings. (The common view in Hungary, though, is that it will be easy to provide a "housing purpose", both because the homeownership rate is 92 percent and most homeowners have some significant maintenance expenses and because the housing expenditures of close relatives can be applied as well (for a loan also).)

Because the Bauspar system in Hungary offers less of an attraction for just saving than in the Czech Republic and Slovakia, it is not expected to be as expensive as these other systems. Another implication is that the Hungarian regulators did not want the Bauspars to count as much on "good brothers" who would not take a loan. They limited the combination of term and size of loan to less than the norm in Germany and also are requiring the Bauspars to retain more of their earnings as reserves.

Despite Hungary's Bauspar scheme being calibrated to attract primarily those with an interest in taking a loan, and not serving mostly as a source of superior return on savings, it was spectacularly successful in its first year, and is likely to become a significant, but not dominant, part of the overall housing subsidy budget. In 3 years, expenditures on state premiums is officially forecasted to be about 0.3 percent of the total budget, the same as in the third year in the Czech Republic.

This may be because of the higher subsidy value of the loan component in Hungary than elsewhere. The market rate on a housing loan has been running between 27-32 percent since 1989 and the value of paying only 6 percent on a Bauspar loan is larger than in the

[28] It is notable that Hungarians are used to receiving subsidized finance for housing renovations. From 1989-93, they could easily borrow from OTP up to about USD 2-3,000 with 30 percent of the repayments subsidized for the first 5 years. Almost 70,000 households took advantage of this in 1993, but when this subsidy was dropped in 1994, the number of borrowers fell by over 90 percent. It is anticipated that this kind of borrowing will start up again 4-5 years after the Bauspars started up.

Czech Republic and Slovakia, where market rates have been between 11-14 percent. Even if a loan is not really needed, and taking one allows retention of other funds in other forms of savings, the return on such savings is running around 15-18 percent, so the spread over the 6 percent on a loan is high. For both reasons, taking a loan after 4 years should be far more attractive in Hungary than elsewhere.

As in the Czech Republic and Slovakia, no aspect of the Bauspar subsidy is automatically adjusted for inflation. This has two major impacts. If inflation continues to come down, the 30 percent premium currently provided in the law will produce an effective return (16 percent) that greatly exceeds what is available on bank deposits. Moreover, the real amount that can be saved under the program and its value relative to housing expenditures will be larger than expected if inflation declines. Thus, the impact of the Bauspar scheme will partly depend on the course of inflation.

An important issue is the extent to which the Bauspars ultimately replace OTP and other universal banks as important sources of housing finance. It appears to be relatively likely to be so. This conclusion is based on the observations (1) that there is usually relatively little loan funding needed by most households to buy a house in Hungary, because of the relatively low cost of existing houses, the high existing equity levels of most potential home buyers (92 percent are owners, usually with little debt), and (2) that there are no subsidies to non-Bauspar financing, other than a 4 percent interest subsidy for new houses. This is considered to be worrisome, since the Bauspar system is a very inefficient way of delivering a subsidy compared to the direct approach which had been traditional in Hungary.

Other Housing Subsidies in Hungary

Hungary has several efforts to support the housing market, particularly the construction of new housing. These are listed in Table 5, along with the amounts budgeted for 1998. By far the largest is the Housing Construction Allowance, which provides a large grant (currently USD 5-10,000) to those with 2 or more children to buy or build a new house. The government has indicated, though, that it expects to let inflation phase out the value of this grant and instead rely on the Bauspar subsidies to a great extent. The Bauspar subsidies are expected to exceed 0.5 percent of the budget as the system matures.

Table 5
Subsidies to the Current Market for Housing Finance in Hungary, 1998

Program	Budgeted Amount (HUF Billions)	Number of Units	Amount per Unit (HUF)	Targeting
Housing Construction Allowance	26.0	16,000	1,625,000	New Housing, 2+ Children
Bauspars	4.0[29]	300,000 contracts	13,000/contract	All Housing Related
Mortgage 4% Subsidy	0.5	?	?	New Housing
20 % Tax Credit on Repayments[30]	0.7	50,000	15,000	New Housing
Total	31.2 (1.0 % of Budget)			

The other two subsidies are relatively small. There is a subsidy on conventional loans for new housing that starts as a 4 percent reduction in the interest for the first 5 years, then declines to 3 percent in years 6-10 and 1 percent in years 10-15. As in the Czech Republic, the cost has not been very great because it is not sufficient to generate much demand for loans.[31] The tax credit applies to the same loans as the 4-3-1 percent subsidy, but is limited at HUF 35,000 per year.

Hungary has a number of other large items that it lists on its "housing budget". As in the other countries, one of the largest is to cover the interest on the low-rate "old loans". Hungary has two cohorts of such loans, for a total outlay of HUF 33 billion. In addition, there are outlays of HUF 2 billion in subsidies for modifying houses for handicapped persons, HUF 2 billion in interest subsidies towards construction period interest for large construction companies (more of a subsidy to large construction companies than to home buyers), and HUF 3.2 billion for Army and police housing, and HUF 14.4 billion in grants to local governments for housing in general, but with no restrictions on its use for other purposes. Thus, in total, the housing budget in Hungary is close to 4 percent of the total budget, while in fact, only about 1 percent is actually going towards effective current support of the general housing market.[32]

[29] This is projected to rise to HUF 8.2 billion in 1999. It will start low because many of the contracts were started in late 1997 and will not receive the first bonus until early 1999.
[30] The only data on this is for 1995, two years after the provision began. Now that 3 years more has elapsed, the number of eligible loan is assumed to have grown proportionately and the average amount claimed stayed the same.
[31] It is notable that in all three countries, there is little interest in taking any loan at all to buy a house if it is not subsidized heavily. In Hungary, fewer than 1 person in every 6 who buy a house take a loan to do so.
[32] The new government in 1998 is planning to increase certain housing subsidies, particularly in the form of an exemption of a portion of housing construction costs from the VAT.

THE CURRENT OPERATION OF THE BAUSPAR SYSTEM IN THE SLOVAK REPUBLIC

Population: 5.4 million (1994)
GDP: Sk.. 654 billion (1997)
State Budget: Sk.. 218 billion (1997)
Exchange rate: Sk.. 34/USD 1.0 (1997)

Description

Slovakia was the first CE country to start up a system of Bausparkassen. The legislation was passed in May 1992 and the aptly-named Prva Stavebna Sporitelna (PSS) or "First Construction Savings Bank" started business in November 1992. It was a partnership between Slovenska Sporitelna (SLSP); the largest German Bauspar, Schwabisch Halle; and a large Austrian Bauspar, Raiffeisen.[33] Soon thereafter, VUB joined with the Wustenrot group to open up VUB-Wustenrot in June 1993. However, PSS has captured about 85 percent of the market.

The Slovak Bauspar system can be summarized as follows:

Main Act:	May 1992, first operations in November 1992
Regulation:	Ministry of Construction regulates and supervises the payment of premiums; Central Bank regulates/supervises the Bauspars, but follows conventional bank regulations, with no additional regulation imposed on liquidity management.
Amount Yearly Premium:	From 1992-1997, 40% of savings, up to Sk.. 6,000. Annual optimal savings was Sk.. 15,000, which was about twice the average monthly wage. In April 1997, the premium rate was reduced to 30%, so the optimal savings amount rose to Sk.. 20,000, about twice the average monthly wage in 1998.
Minimum Saving Period:	6 Years to get housing contractual loan (usually at 6%) if 50% of contracted sum is saved. But possible to get an interim loan at a higher rate after 2 years. Originally possible to cash savings and keep premium even after 1 year. Then changed to minimum of 6 years but not

[33] Some indication of the momentum towards creating a Bauspar system can be gained from noting that the PSS had already been incorporated in 1991 and then worked persistently to get the necessary legislation passed.

necessarily for housing. As of 1997, use for "housing purpose" is required to cash the premium even after 6 years.
Housing purposes to be demonstrated by invoices (initial provisions allowed for taking a loan for non-housing purposes).

Main housing use: Mostly privatization of municipal flats, repairs and renovations, and purchase of existing flats.

The Bauspar system grew quickly in Slovakia. This was partly because, in its original format, it offered the peculiar opportunity to cash out of an account after one year and still keep the premium. Simple arithmetic suggests that the optimal savings policy would be to do that each year, rather than save for several years. (It is not known why and how this provision got enacted.) But even without these extraordinary returns being available, the tax-free 40% premium promised a higher after-tax return on Bauspar savings than on unsubsidized market opportunities.

Table 6 gives the cumulative results of the system.

Table 6
Activities of Bauspar Banks in Slovakia

	1993	1994	1995	1996	1997	1998 (est.)
New Contracts (000)	?	?	?	?	?	
Net Contracts (000)	228	432	644	923	907	
Net Savings (Bil. SK.)	?	?	12.9	21.1	32.6	
Net Loans (Bil. SK.)[34]	0. 0	0.0	0.0	0.3	2.2	6.0
State Premiums (Bil. SK.)	0.0	0.5	1.5	2.9	3.0	3.2
Premiums/State Budget (%)	0.0	0.3	0.9	1.5	1.4	1.3

Other relevant aspects of the system include:

- the interest and premium on savings are exempt from taxation;
- premiums are paid into the account within one or two months after the end of the "contract year" (the 12 month cycle since start of the account);
- the interest paid on the loans is not tax deductible, but neither is interest on loans by regular banks;
- there is no penalty for irregular savings patterns;
- both institutions offer only 3 percent on savings, under all conditions;

accounts can be tied to issuance of a market-rate housing loan immediately (by the parent commercial bank), repayable by the savings and loans proceeds after 2 years; and

[34] This includes only loans to regular clients. In 1997, there were also about Sk.. 200 million in loans to companies for construction.

- the parameters of the state premium are not embedded in law and can be set for new contracts by the government annually as part of the budget legislation **(very important)**.

As in the Czech Republic, the Bauspars have been very successful in drawing in savings. Their success has partly been due to the extensive marketing that has been done on their behalf and partly due to the attractiveness of the financial return on savings, independent of the value of the housing loan. Over the minimum 6 year savings period, the 40 % premium on the annual contribution, on top of a 3 % return on accrued savings, was yielding an after-tax return of about 13-14 %. Even at the lower 30% return applicable after 1997, the return is over 11%. These returns have been significantly more than most alternatives, especially bank deposits at about 10%.

After 1993 and through April, 1997, the maximum amount of subsidy was achieved by saving at a rate of Sk.. 15,000 a year for 6 years. With interest and premium, this would provide total savings of about Sk.. 130,000 after 6 years. Matched with a loan of the same size and with a second savings amount and loan for a spouse, a couple can acquire a total of over Sk.. 500,000 towards a housing investment. This is a relatively large amount, about USD 15,000, more than 50% of the cost of a modest existing flat, but only a quarter to a third of the cost of a more substantial flat or a new flat or a family house.

However, as in the Czech Republic, the average amount of saving actually done per contract is only about half of this maximum amount (but growing over time). Notably, relatively few have taken a loan so far, despite the early start of the system and the availability of low-rate bridge loan. Total borrowers in Slovakia through 1997 were about 17,000, or about 2.0 per 100 contracts, in contrast to a ratio of 4.2 per 100 in the CR. Some observers expect that a large portion of savers (40-70 percent) appear to be simply happy to receive the higher after-tax return on their savings and not take out a loan.

The history of the Bauspars in Slovakia also reflects the quirk of the Slovakian law that initially set them up. The original contracts allowed for withdrawal of the savings, interest and premium at any time. Given that the premium was a one-time bonus of 40 percent of the saved amount in a year, up to Sk.. 6,000, it quickly became clear that the way to maximize the return on savings would be to withdraw it after one or two years. This has largely happened with respect to the early contracts. As of the end of 1997, about 400,000 contracts had been closed (30 percent of all contracts ever opened) for a total withdrawal of over Sk.. 7 billion, or 19 percent of all savings and premium ever accrued. This also has prevented the maturation of a large number of early contracts into regular loans.

An interesting aspect of the Slovak Bauspar system has been the political dynamics. In both the Czech Republic and Slovakia, there has been much comment about how little impact the Bauspar systems have had on actual housing investment. However, there is a significant difference in how the political system has responded to this concern. In

Slovakia, the government itself has control of the annual premium level. As is discussed below, the result has been a heightened sensitivity of the Bauspar banks to making as many housing loans as possible and a movement by the government to squeeze some of the subsidy back out of the system to subsidize housing in other ways.

As noted above, there were about 900,000 contracts in place with the Bauspars at the end of 1997. Completed savings plus premiums totaled about Sk.. 29 billion by the end of 1997, or about 12 percent of total bank deposits of the household sector. In 1998, this will entail payments of about Sk.. 3.2 billion in premiums. This is the largest form of subsidy to housing in Slovakia. Moreover, the government has cumulatively paid about Sk.. 9.7 billion into the Bauspars since the start of the system in 1992.

This fact has been the source of much controversy. Through 1997, the Bauspars had made relatively few loans for housing and appear to have had little effect on housing activity, compared to, say, spending this amount on direct construction or lump-sum subsidies.[35] In some ways, this is not surprising, since the basic contract with the Bauspar calls for the completion of a 6 year savings program. Since 1993 was the first year that many contracts were started, one might not expect a significant number of loans to be completed before 1999.

However, the Bauspar offer "bridge" loans after only 2 years of saving that essentially allow for borrowing now and payback through completion of the normal Bauspar savings and borrowing cycle. Still, relatively few have taken these loans. This may be because the effective interest rate while awaiting completion of the savings contract had been, until 1997, the market rate, about 12-13 percent, and few were interested in borrowing at the market rate. However, in 1997, under the political pressure to show results, the Bauspars cut this rate in an effort to encourage additional borrowing, even at effective rates to them that were much less than what was available on government bonds, the major alternative form of investment. They also made contracts assignable to any "first-rank" family members to further encourage borrowing

The Bauspars have gone further to introduce what are called "instant loans", which do not require any prior regular savings, but do require deposit of an amount equal to half the loan amount with the Bauspar. The interest rate on the loans is stated as only 7 percent, but the effective rate is twice that, because the rate applies to the full amount of the savings and loan contract. However, in 1997, in order to encourage more lending, the Bausparkassen reduced this rate to 5 percent, which is truly below-market.

[35] Even as of 1997, a full 5 years after the system started, only about 20,000 loans had been disbursed by the Bauspars, a ratio of loans to contracts about half the relatively low ratio in the CR. This has also meant that the Bauspars are able to make extraordinary profits. For example, in 1997, the dominant Bauspar, the PSS, had gross income of Sk.. 3.3 billion and ordinary expenses of Sk.. 1.5 billion. The remaining Sk.. 1.8 billion would have been a 150 percent return on capital, except that most of it, Sk.. 1.4 billion, was put into reserves.

The weak demand for loans from the Bauspars can be attributed to at least three factors. First, the initial rate of premium of 40 percent created a rate of return that was so high that the Bauspars attracted many people who had no interest in borrowing for housing. Second, the initial savers could cash out their premiums without completing the contract, most did so, and thus most current contracts are only 3-4 years old. Third, as described below, since 1996 the government has provided loans on new housing at only 1 percent and with no prior savings requirement.

In any case, the controversy over the inefficacy of the Bauspar to resurrect housing production has been fairly intense. It is all the more relevant because the government can unilaterally alter the level of premiums available to new savers in each year's budget. This implies that the bonus and the other parameters of the system have been able to be changed without the ability of the Bauspar interests to apply pressure in the Parliament. Because of this, the Bauspars have to negotiate directly with the government about their activities and about the size of continued subsidies. Another result has been a publicity effort by the Bauspars to claim that much of the subsidy has flowed into housing in some way or another.

An additional result has been an *ex post* extrication of subsidies through the successful "persuasion" by the government for the purchase by the Bauspars of bonds issued by the State Housing Fund at a below-market rate. Over Sk.. 1 billion in such bonds have been bought by the Bauspar, at a rate of 10 percent, significantly less than the rates of 15 percent or more on conventional government debt. These funds are then channeled into immediate low rate loans by the State Housing Fund that are unconnected with any prior savings, and allow the Bauspars to claim that they are supporting housing construction.

The Bauspars are also trying to develop more business in construction financing (over Sk.. 700 million in 1997) and any other lending endeavor which can be linked to housing.

In addition to these efforts to channel more of the past Bauspar subsidies into housing, the government has taken some actions to tie the Bauspar contracts more closely to housing and also reduce the extent of future subsidies for simply saving and not investing in housing. For contracts started after 1 January 1997, withdrawals, even after the 6 year savings period, will not get the state premium unless invested in housing. Also, after 1 April 1997, the premium level was cut from 40 percent, which clearly generated above-market returns on savings, to 30 percent, which generates after-tax returns which are only about equal to currently elevated interest levels in the country. These actions significantly slowed the growth in Bauspar accounts (and in the burden on the state budget).

Other Housing Subsidies in Slovakia

Partly because the public was so disappointed by the feeble effect of the Bauspar system, the government decided to make a more direct intervention into housing construction. In

1995, the government pumped in Sk.. 2 billion towards finishing about 2,000 municipal rental flats that had been over 20 percent complete as of 1992.

Then in 1996, the government set up a State Housing Fund and started offering low-rate loans to qualifying households. The usual arrangement includes a grant portion of Sk. 150,000 and a loan of Sk.. 500,000, for a total financing package of Sk.. 650,000. The term of the loan is 30 years and interest rate is set at either 1 percent or 3 percent. (The higher rate is supposed to apply to any families with above-average income, but because such households are generally self-employed, they are usually able to "prove" a lower income and so far almost all applicants have qualified for the 1 percent rate.) Such an amount is about half of the cost of a modest new flat (60 sm., at Sk.. 20-25,000 per sm.), but only 25-30 percent of the cost of a new family house or larger flat.

The advent of this funding created a major revival in construction activity. Housing starts doubled from 6,433 in 1996 to 12,844 in 1997, supported by 1,000 loan approvals in 1996 and another 7,000 in 1997. The expectation is for another 8-9,000 approvals in 1998. This impact is not surprising. This program goes back to the sort of deeply subsidized long-term loan that the public had experienced before 1989 and also constitutes a substantial financial incentive. The present value of the repayments on a 1 percent loan over 30 years, when market rates are 15 percent, is only about 20 percent of the original principal. Thus, the Sk.. 500,000 loan is the financial equivalent to a grant of Sk.. 375,000, for a total grant of Sk.. 525,000. The opportunity to obtain such a subsidy, when the typical family net income is less than Sk.. 200,000 per year, is not to be missed.

In the first year of the program, only Sk.. 800 million was actually disbursed. In 1997, disbursements jumped to Sk.. 1.7 billion and another Sk.. 3.5 billion may be disbursed in 1998. Only about Sk.. 1 billion of the funding for the State Housing Fund has actually come from the government budget. The rest has come from below-market bonds sold by the fund to the Bauspars or contributions from the National Privatization Fund. It is unclear how sustainable this rate of funding is. Moreover, some claim that the fund will lose priority once the elections due for this fall are over.

Table 7
Subsidies to the Current Market for Housing Finance in Slovakia, 1998

Program	Budgeted Amount (Sk.. Millions)	Number of Units	Amount per Unit (Sk..)	Targeting
Bauspars	3,200	900,000 contracts	3,555/contract	All Housing Related
State Housing Fund	3,500[36]	5,400	650,000	New Housing
Total	6,700 (2.8 % of Budget)			

Slovakia does also provide a subsidy to mortgage banks through the tax exemption of the bonds. However, there have been no bond issues and mortgage lending by the two banks which make loans, Slovenska Sporitelna and VUB, has been very weak in the face of deeply subsidized alternatives through the Bauspars and the State Housing Fund

Essentially, Slovakia provides no other subsidies to support the housing sector. There are payments of about Sk.. 1.5 billion a year to cover the costs of extra interest payments on the "old loans". In 1997, there was also a subsidy of Sk.. 2.6 billion counted in the housing subsidy to assist with the payment of energy costs in co-ops. Thus, the official "housing budget", which excludes the cost of the State Housing Fund, was 3.4 percent of the total budget in 1997.

[36] None of this amount appears on the official budget. It is being raised through funding from the proceeds of the privatization of enterprises and from bonds being sold to the Bauspars.