THE TRANSITION IN HOUSING FINANCE

IN CENTRAL EUROPE AND RUSSIA: 1989-1999

Prepared for

Support for Economic Growth and Institutional Reform
CLIN 002: Legal and Institutional Reform
U.S. Agency for International Development
Contract No. PCE-I-00-97-00052

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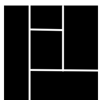
Under Subcontract to Price Waterhouse Coopers LLP



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November 1999
UI Project 06933-002

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ABSTRACT

This analysis is based on interview and other data collected in June 1998 and updated in mid-1999 as part of a study sponsored by USAID through the Urban Institute. It reflects solely the knowledge, understanding and views of the author, and has not been reviewed by any country authorities or by USAID.

This report describes and analyzes the past and near-term prospects for housing finance in Russia and four Central European countries (the Czech Republic, Hungary, Poland, and Slovakia). The focus is on the policies, institutions, and forces shaping the market today, but the starting points and transition process are also covered.

Three major conclusions are drawn. First, all four Central European countries have adopted similar institutional structures for their new housing finance systems. Second, homebuyers in Central Europe are so far unusually reluctant to borrow, even at subsidized low real rates, unless rates are below the return on bank deposits. However, mortgage market in Poland seems to be growing at an accelerating pace. Third, the Bausparkassen-type institutions, which have been very popular, may supplant mortgage or commercial banks as the primary housing lenders in all countries other than Poland, even though they will not provide the sorts of public benefits expected.

With respect to Russia, the housing finance sector has made greater progress towards market-based operation than the economy as a whole. Partially due to continuing USAID-funded technical assistance, the sector is poised to develop rapidly whenever macroeconomic conditions grow more supportive of long-term lending.

CHAPTER 1

SUMMARY AND CONCLUSIONS

I. INTRODUCTION

As of 1999, the four major countries of Central Europe (CE) have completed a decade of economic, political, and social transition. Russia both began the process later and has been slower to build the social and legal infrastructure necessary to support a market-based economy. All the countries have struggled to mold new, market-based financial systems out of the institutional and legal legacies of central planning and state direction of investment decisions—with provision of long-term finance for private investment in housing an important part of the task.

Even though creating, nurturing, and regulating housing finance systems have received extensive attention for over a century in Western capitalist economies, there has been much inefficiency and financial trauma, even relatively recently. Thus, it is not surprising that housing finance remains very much in evolution in all transition countries, even the most advanced. As economic stability and significant real income growth is achieved in these countries, housing finance will start to reach the prominence already accorded it by the public and in the financial sectors of most developed countries.

This report assesses the past and near-term prospects for housing finance in the four major Central European countries, the Czech Republic, Hungary, Poland, and Slovakia, and in Russia. Its purpose is twofold: to provide analysis useful for the continuing development of housing finance in these countries and to inform policy discussion in countries at earlier stages of the transition process.

Chapter 1, Summary and Conclusions, together with its Annex summarizing the major housing subsidy programs, serves as a stand-alone document covering the main points of the report. The four CE countries are treated comparatively. Since Russia has had such a different overall experience, it is discussed separately, with similarities and contrasts with Central Europe noted as appropriate. Chapters 2 through 6 cover in detail the transition process and present status of housing finance in each country.

II. THE STEPS TO TRANSITION

Similar Starting Points

The housing finance systems of the Czech Republic, Hungary, Poland, and Slovakia are strikingly similar in their starting points, and—despite their different policy evolutions—also in their current situations.

During the Communist era, for example, three modes of ownership and financing predominated:

(1) State/municipal/enterprise rental
(2) Cooperative/condominium
(3) Owner-occupied family houses

All four countries after World War II initially emphasized production of state- and enterprise-owned rental flats, with a shift in the 1970s towards greater production of privately "owned" units in co-operatively owned buildings or freehold condominium flats. Throughout the period, obtaining an owner-occupied family house remained possible, if one could procure the needed land and building materials.

The result was that, despite state domination for 40 years, the overall housing stock was still predominantly in private hands (unlike in Russia). As of 1990, the four CE countries boasted 20.8 million units, distributed in the following manner:

— Owner-occupied: (Including co-ops):	61 percent
— Public Rental: (Including employer and rental co-ops)	38 percent
— Private Rental:	1 percent

As of 1989, new housing was being financed in several ways. Construction of rental units had been cut back sharply, to fewer than 10 percent of new starts in Hungary and Poland and about 20 percent in Czechoslovakia. Co-operatives or condominiums (in Hungary) were the principal form of new housing in urban areas, which benefited from state grants and deeply subsidized finance from the state savings banks. Builders of family houses also had access to long-term financing from the state savings bank, at 1.0-3.0 percent, usually for 30-40 years.

The net effect in all four countries was a substantial block of long-term low-rate housing debt, which became a significant burden on government budgets as inflation shifted a major portion of the real cost burden of this owner-occupied stock from the owners to the state (see Table 1-1).[1] In addition, all four countries have legacies of low municipal and enterprise rents (originally set at nominal levels), and maintenance shortfalls that have yet to be addressed.[2]

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[1] The high level of inflation has partially thwarted the state's intention of shifting more of the burden on individuals by reducing the funding of public rentals and boosting that of owner-occupied housing.

[2] In co-ops and condominiums, charges usually covered regular maintenance, so the state avoided that burden. The main explicit subsidy was on utilities, which has since disappeared.

TABLE 1-1
BURDEN OF LOANS MADE ON DEEPLY SUBSIDIZED TERMS[3]
(based on data for various years, 1994-1996)

	Czech Republic	Hungary	Poland	Slovakia
Amount of Old Loans (US millions)	800	1,000	1,800	390
Payments as Share of Budget (in percent)	0.8	1.4	1.5	0.7

Several important adjustments in the housing and housing finance sectors were made in all four countries between 1989 and 1995. New legislation provided for the transfer of most state-owned stock to municipal governments and privatization of that stock to sitting tenants. Slovakia and the Czech Republic also provided for the restitution of pre-war rental stock (with sitting tenants at controlled rents).

Only in Hungary was there significant privatization, however. The other three countries kept either rent levels so low or privatization prices so high that it was more attractive to remain a "renter"—with nearly all the legal prerogatives of an owner but lower outlays for maintenance (and lower actual maintenance). The result was that, by 1994, Hungary was the only country to show a significant increase in its owner-occupied stock.

All four countries had also entered recessions by 1990, although they followed somewhat different paths out of them. According to official figures (which presumably understate the growth in the black economy), the recessions bottomed out in 1993 in all but Poland—which endured a particularly rapid decline, but was one year ahead in both decline and recovery.

With respect to inflation, the countries diverged. The two parts of Czechoslovakia brought inflation down rapidly after an initial run-up, and have kept it in the range of 10 percent or less, considered supportive of normal housing finance. Hungary and Poland struggled with inflation rates of over 15-20 percent and interest rates over 20 percent, but finally appear also to have conquered inflation. These different inflation environments did not translate into significant differences in the use of mortgage finance, however, as discussed below.

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[3] In all cases, these figures include loans made after 1989 and as late as 1994, either on the same terms as in 1989 or on other deeply subsidized terms.

Momentum of the Past: 1989-1992

As their command economies collapsed, these countries suddenly needed new mechanisms for financing the housing sector, especially construction and renovation. Private-sector finance for private-sector housing was not something that government policy makers or bankers in any of the four countries were familiar with as of 1989. All had much to learn and understand before a new system for the provision and payment of housing in general, and for housing finance in particular, could be designed, implemented, and accepted by the public.

The most advanced in this area was Hungary, which had grown to depend more on individual households for housing finance and production than did the other countries. Although all four countries used the basic lending mechanism used in Hungary (the below-market fixed-rate loans made by the state savings bank), their use by the general public was far more common in Hungary. While the other countries emphasized municipal flats or large loans to co-operatives as a means of financing the large-scale construction of panel flats, Hungary had gradually shifted towards the sale and financing of such flats to individuals through the condominium format. Access to land, infrastructure, and materials for the construction of family housing was also easier in Hungary.

The similarity of such lending to Western-style housing finance, however, was only skin-deep. The financial systems were, in fact, entirely constructs of monopoly state-controlled institutions, operated by central planners and generally outside the forces of supply and demand. The lending and loan recovery process were based on the propositions that (1) most citizens worked for the state, (2) the state was integrated with all economic and financial institutions, and (3) economic uncertainty was minimal for the individual. The credit-worthiness of would-be borrowers was evaluated only cursorily and enforcing loan recovery relied on wage garnishment.

These difficulties were not unique to the housing finance sector. But, other parts of the economy generally received most of the attention in the very first reform years, with reform of the housing sector deliberately delayed. The need to delay became more urgent with intra-COMECON trade collapsing, because the housing sector became increasingly relied on to maintain employment. Thus, all the countries continued to channel significant subsidies into an unreformed housing sector in the years immediately after 1989. Table 1-2 shows the trends in housing completions, with the 1989 level set at 100.[4]

[4] It should be noted the apparent low levels of activity in Slovakia and the Czech Republic are in the process of being reversed, with both countries reporting housing starts in 1997-8, fed by strong subsidies, at 300-400 percent of the levels at their lowest point.

TABLE 1-2
TRENDS IN HOUSING COMPLETIONS, 1989-1998 (1989 = 100)

Year	Czech Republic	Hungary	Poland	Slovakia	Russia
1989	100.0	100.0	100.0	100.0	100.0
1990	80.9	85.0	89.3	74.0	84.1
1991	75.7	64.5	91.1	62.3	75.7
1992	66.1	50.1	88.9	49.1	54.9
1993	57.2	40.6	62.8	41.9	54.9
1994	33.0	40.6	50.7	20.1	49.2
1995	23.0	48.0	44.7	18.6	48.7
1996	26.3	55.0	41.3	18.7	38.8
1997	30.4	54.6	49.1	21.6	34.6
1998	40.3	39.4[a]	53.7	24.9	31.2
Avg. of 1990-1998	48.1	53.1	63.5	36.8	52.5

Note:
a This figure was distorted by delays in completions due to hopes of becoming eligible for increased subsidies from the new government. Completions are expected to rebound in 1999.

Czechoslovakia (and the Czech Republic and Slovakia after 1992) focused on completion of public rental and co-operative projects already started. This initial burst of continued subsidy died down after 1990, when it was hoped that the private market, together with market-rate housing finance, would begin to fill in for state-sponsored construction without significant subsidies. However, new housing starts (not shown) dropped by over 80 percent in each country between 1990 and 1991 and stayed low until 1995. (The more rapid decline in completions in Slovakia reflects insufficient funding to complete all the municipal flats that had been started).

In Hungary, large additional subsidies were committed to private home buyers through a modified scheme of deeply subsidized mortgage lending, equal to about 20-25 percent of the cost of a new home, plus a grant for another 10-12 percent. However, rapid inflation steadily reduced the value of the set amount of subsidized loan and grant assistance, and housing activity shrank. Even so, housing completions fell less overall than in the Czech Republic and Slovakia, because of Hungary's new deep subsidy commitments after 1989 and because production in Czechoslovakia had been more dependent on direct state budget support to begin with.

Poland's downward trend in housing completions was the mildest. This was because authorities used the housing sector as an economic buffer more than in the other countries, by continuing to make subsidy commitments for hundreds of thousands additional units (mostly co-ops to be constructed in 1992-1995) through 1991 and by starting up a major new tax subsidy in 1992. The magnitude of these efforts is reflected in the high burden on the budget of "old loans," which is almost totally due to loans issued after 1988 (since earlier loans were not indexed, their value disappeared during the hyper-inflation of 1989-1991).

Russia has also used the housing construction sector as a macroeconomic tool. Despite economic difficulties and tight budgets, the flow of funds into Russia's housing sector has been maintained at a per capita pace similar to that in the more economically resilient Central European countries. However, the bulk of Russia's housing was, and still is, public rentals financed by government budgets.

Subsidy Cutbacks and a Round of New Subsidies (1993-1995)

The view seems to have been common in these countries that improved access to housing finance was key to the housing sector's recovery and that it could bounce back from its depressed situation if housing finance became more available. All of them took their first steps towards creation of a market-based housing finance sector around 1992-93, as the impacts of earlier efforts to support continued housing activity died down, although the paths the chose were somewhat different.

Slovakia inaugurated a building societies scheme (modeled after the German Bausparkassen) in November 1992 with the Czech Republic following in 1993. Since both seemed to hope these schemes would provide some immediate support for housing, they did little else to support housing or housing finance.[5] Unfortunately, a building society system is not capable of such support. Even the earliest system, in Slovakia, had no impact on housing until recently (partly because of flaws in the original design). Meanwhile, the former state savings banks in both countries stopped making long-term housing loans entirely.[6] From 1992-1994, there was essentially no mortgage system in neither country nor any deep subsidies to new construction.

Hungary finally halted its deep subsidies to mortgage borrowing at the end of 1993, and started to focus on developing a regular market-based housing finance system. The savings bank revamped its mortgage program, which had continued to be very active since 1989, and introduced more appropriate underwriting and loan recovery procedures. The government also worked with the savings bank, using the Deferred Payment Mortgage design to provide a more "affordable" housing loan.

Poland had attempted to cut back on the flow of subsidies even earlier, in 1992.[7] In 1990, it had already shifted to an inflation-indexed mortgage scheme through its state

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[5] In direct translation, the names of these institutions usually means "construction (or housing) savings banks", but they prefer to be called "building societies" in English and that usage is adopted here.

[6] In contrast to Hungary and Poland, the Czech Republic and Slovakia did not have the problem of inflation making housing loans unaffordable. Perhaps because of this, there was no effort to deeply subsidize mortgage lending. In the absence of a deep subsidy program, the savings banks apparently did not feel any pressure to offer long-term mortgages at all.

[7] It is said that the cutback was only "attempted" because (1) another large subsidy was installed at the same time, the tax deduction discussed below, and (2) an implicit subsidy to lending was introduced as well.

savings bank, but with relatively low current repayments and a large current and future subsidy from the state. In 1992, this scheme was modified into a regular Dual-Indexed Mortgage, with payments expected to rise with incomes and eventually cover the full accrued interest with no state-subsidy. The scheme was soon seen to be flawed, however, because the initial payment was set unrealistically low.[8] Poland's DIM loan system became truly unsubsidized only in 1995.

Around this time, several of the countries started to focus on developing the legal and institutional infrastructure needed to operate an effective private housing finance system. The most basic of these involved diluting or removing the traditional requirement that defaulting borrowers be provided with equivalent accommodation elsewhere. Hungary passed such legislation in 1993 and the Czech Republic in 1994. Later, Hungary also revised its civil code to permit mortgage contracts to provide for expedited adjudication in cases of foreclosure.

Despite these moves, all four countries saw further declines in 1993 and 1994 in the number of housing completions. This is not surprising, considering the sharp decline in real incomes in the preceding years. Even though the economic recovery was now boosting the number of housing starts (housing start data are available only for the Czech Republic and Slovakia in this period), the political winds turned strongly towards more definitive action to boost housing production. Each country responded in its own manner, but all emphasized new direct subsidies for housing construction, usually in addition to stronger efforts to encourage housing finance.

In November 1994, Hungary greatly expanded an existing lump-sum subsidy to cover 25-60 percent of the cost of a modest new house for families with two or more children. In 1995, the Czech Republic started a new program of deep subsidies for municipal rental flats, followed in 1996 with subsidies to mortgage finance and in 1997-1998 by even more subsidies to home buyers. Also, in 1995, Slovakia provided a large amount of funding for finishing the remaining stock of unfinished panel flats. In the same year, it started planning for a new major initiative to encourage housing construction, the State Housing Fund, which started operations in 1996 and has been funding a large share of new housing starts ever since. In 1995, Poland took a similar approach (on a smaller scale), with formation of the National Housing Fund (NHF) and

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[8] The low level of initial payment made these loans very affordable, but made it very likely that the accruing deferred interest could not be amortized over the maximum term. Thus, while these loans were explicitly unsubsidized, the public and eventually public officials recognized that the government would be forced to subsidize them *ex post.*

enhancement of the subsidy component of the NHF in 1996.[9] (Annex 1-1 provides short descriptions of the principle subsidy schemes related to housing finance in each country, including Russia.)

Partly as a result of the new subsidies, and partly because of the economic recoveries, most of the countries are reporting substantially higher housing activity in 1998 than around 1994. In 1996-97, for example, Hungary's housing completions were one-third higher than its 1993 low point. In 1998, both Slovakia and the Czech Republic had completions up significantly from their 1995 lows, and recent housing starts are still much higher than completions. Poland is the exception. Because of continuing subsidy support and extended construction periods, completions did not hit bottom until 1996, and rebounded only modestly in 1998. But Poland has maintained the highest average subsidy levels and thus average production levels over the period as a whole, relative to 1989, with completions averaging 64 percent of the 1989 level.

III. THE ARRIVAL OF MARKET-BASED FINANCE

Despite renewed reliance on direct subsidies to support housing construction, work continued on the economic, legal and institutional building blocks of an active private housing finance sector. After 1993, all four countries made great progress in the most critical arena, macroeconomic conditions, including reducing inflation and promoting real income growth. All four moved towards strengthening their financial systems, especially their banking sectors, and developing a better basis for loan recovery—although none have unequivocally succeeded in either regard. All four have now taken steps towards creating private pools of pension funds, which could make a more desirable base for funding mortgages. And four are attempting encouraging competition and innovation in retail banking.

A Commonality of Institutional Structure

By 1998, all four Central European countries appear to have moved towards an institutional structure for providing private housing finance, which includes the same three basic elements. These are a strong universal banking sector, a deeply subsidized building society sector, and some version of mortgage banking as a potential mode of accessing housing funds from the capital markets.

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[9] Poland actually never did reduce its subsidy support to housing to the extent of other countries. In a step that seems to have been a precursor of the resurgence of subsidy schemes in the other countries in 1994-1995, Poland introduced a new subsidy vehicle in 1992, to replace the mortgage-related subsidy in effect up to then. The subsidy was based on deductions of housing investments from taxable income (up to an amount equal to the cost of 70 square meters of housing), and thus operated outside of mortgage lending. It has been very costly, estimated to have lost in revenues an amount equal to 2.7 percent of the state budget in 1996, but it has been effective in maintaining new construction levels at close to half of the level in 1989.

On paper at least, these housing finance systems are very similar to the systems in Germany and Austria. This appears to be neither a coincidence nor because of historical linkages between these and the German-speaking countries. Anecdotal evidence attributes it to direct efforts by commercial interests in Germany and Austria to develop new fields for their proprietary skills and systems.

Part of these efforts involves promoting the concepts underlying the archetypal model of the German housing finance system. At the core of this model are specialized "housing savings" institutions (*Bausparkassen*) and the assumption that anyone who completes a savings program is a good credit risk. Steady savings towards the equity investment in homeownership is rewarded by state-supported premiums, and low interest rate on savings permits the offering of a low-fixed rate on a loan about the same size as the built-up savings.[10] An additional loan up to a very conservative loan-to-value (LTV) ratio is funded through nearly riskless bonds issued by specialized and carefully regulated mortgage banks. Commercial banks play only an ancillary role—offering any additional funding that can be afforded after securing the first two loans.

This model roughly describes the reality of housing finance in Germany in the early post-war period. However, the evolution of most financial systems towards less specialization and segmentation has greatly diluted it in practice. In modern Germany, the lines between Bausparkassen, mortgage banks, and commercial banks are more in the regulations than in the minds of borrowers or even lenders. Nearly all major such institutions are knitted together as affiliates in joint ownership and their products are sold jointly, as a package. Bonds issued by regular banks have rates almost as low as those issued by mortgage banks. One major supposed advantage of a Bauspar savings program—that the long period of regular savings reveals the “reliable character” of borrowers—is frequently passed over in favor of making a "bridge" loan early in the savings program if not immediately.

Just as this system is more mythological than real today in Germany, the actual structures adopted in each Central European country vary across countries and from the German model. This variation is most notable in the mortgage banking structures. In the Czech Republic and Slovakia, mortgage banking has effectively become an activity subsumed under ordinary commercial bank operations. It looks very much the same as ordinary mortgage issuance by commercial banks anywhere in the world, except to the extent that the mortgages are used as segregated collateral to back the issuance of mortgage bonds. In effect, supposedly German-style mortgage banking in these countries has simply given commercial banks an additional potential tool for

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[10] The nature of the Bausparkassen model is discussed at greater length in the chapter on the Czech Republic. An even more in-depth comparison of the BS systems in Central Europe is available in the report by this author entitled "The Current Operation of the Bauspar Systems in the Czech Republic, Hungary, and Slovakia", Urban Institute Consortium, September 1998.

raising funds for mortgage lending, not dissimilar from the use of mortgage-backed securities in France and many Anglophone countries.

Hungary and Poland so far have adhered more closely to the traditional model of mortgage banks as specialized institutions operating under special rules (as opposed to ordinary commercial banks issuing specially designated bonds). It is too early to tell whether such an approach will offer enough real world value in fund-raising to support the extra costs and inefficiencies of specialized and segmented institutions. But a number of reasons suggest that it will not, including the low liquidity of mortgage bonds and the weakness of the basic premise that low-LTV mortgage loans are nearly riskless.

All the major Central European countries, with the notable exception of Poland, have adopted some form of the German Bausparkassen system, with Hungary joining the Czech Republic and Slovakia in 1996. The specifics of the Building Societies are close in spirit and in substance to the original Bausparkassen model, but still vary significantly among countries. (Many of the most important parameters are noted in Table 1 of this chapter's Annex 1.) It is difficult to generalize about them, other than to note that they are all structured around institutions that are legally separate from the commercial banks (but usually controlled by and integrated with commercial banks) and that the Building Society programs are likely to be the single largest housing-related subsidy recipient and, not coincidentally, the largest housing lenders in each country.

Poland eventually declined to adopt the Bausparkassen model. It accepted the view that such an approach to widespread subsidizing of housing loans is inherently inefficient, particularly with respect to use of a segmented institutional structure. Poland has so far pursued a more limited form of contract savings program, which is operated by commercial banks as a normal part of their operations. It appears likely that this program itself will soon be modified.

Growth of Competition

In the 1994-95 period, all four countries established programs of conventional market-rate housing finance through commercial banks. The market leader in three of the cases was the former state savings bank, still the predominant retail banking entity. In Hungary and Slovakia, the savings bank essentially had a monopoly in the market at that time. In Hungary, it appears that the bank made use of this monopoly to keep spreads high on mortgage lending, with the extra benefit of also keeping returns high on the portfolio of subsidized older loans. In Slovakia, continuing influence of the state over the savings bank translated into a below-market margin on housing lending, both diminishing the bank's interest in making such loans and also protecting its monopoly on lending.

In the Czech Republic and Poland, true competition had appeared by 1995. The Czech Republic passed legislation setting up mortgage banks and soon there were

three such banks (associated with the three major commercial banks) competing to lend for housing.[11] In Poland, some competition had appeared as early as 1993. Many banks were also showing increasing interest in developing more of a retail banking activity; by 1996, a total of 18 banks were offering housing loans of some kind.

As of 1998, all four countries have at least some competition in the provision of conventional mortgage finance. Slovakia still has the least, with relatively few loans being made by the only commercial bank competing with the former state savings bank. Hungary is the next lowest in this regard, with some serious competition for the former saving bank appearing in 1998. Poland has seen expansion to the point today that there are well over 20 banks offering some type of housing loan, and 13 making extensive efforts. Despite this, however, the old savings bank, PKO-BP, still makes about 60 percent of the loans by value.

Measured by market share, the Czech Republic has the most competitive system. The mortgage bank sections of its major commercial banks are very active in competing for mortgage business of ordinary households and no one bank is dominant. In fact, the largest volume of mortgage lending is by one of the traditional commercial banks, apparently because the old savings bank was slow in re-entering the market after having stopped all mortgage lending from 1992 to 1995.

Despite efforts during this middle transition period to facilitate loan recovery, bankers in all four countries report a variety of remaining concerns. These are not preventing them from pursuing mortgage lending, but are probably keeping them from competing as aggressively as they might with better loan recovery mechanisms.

IV. CURRENT MARKET ACTIVITY

The Small Role of Market-Rate Finance Currently

Despite the presence of funding, declining interest rates, and rising competition for customers, Central European activity in market-rate housing finance remains remarkably low. This is documented in detail in the country chapters. Here is a comparative overview.

Hungary, until recently, has had the highest rate of loan issuance per capita and per housing transaction, presumably because of its longer tradition of individual borrowing for housing purposes. In 1993, the last year in which almost all housing loans were subsidized, about 240,000 loans were taken by individual households. This

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[11] Housing loans granted by mortgage banks were given three advantages: (1) the 4 percent subsidy if for new housing, (2) tax-exemption of the mortgage banking business, and (3) tax-exemption of mortgage bonds (irrelevant so far).

massive number was bloated by 126,000 loans for utility connections and 71,000 loans for unit renovations, both of which were commonly recognized as used primarily to capture deep subsidies, rather than because of a compelling need for financing. About 43,000 loans were taken for home purchase, many of them also obtained primarily to capture the deep subsidy.[12]

In almost all cases, the net-of-subsidy rates on such loans implied a negative real rate and a nominal rate lower than that on savings deposits. After 1993, however, subsidies were removed from all but loans for new construction, and even there the effective rate rose to above the deposit rate, eliminating the outright income-generating aspect of the financing. Loan activity has shriveled. In 1998, about 18,000 housing loans were taken for all reasons, although the pace of housing sales was higher than in 1993.

Some of these loans were made under a grandfathered "youth savings" program that conveys deep subsidies. Netting out these and loans made for rehabilitation, leaves about 8,000 loans made to finance the purchase of a house—down from 43,000 in 1993. Of these, 2,800 were for new housing, most of which benefited from a 4 percent buy-down in the interest rate for the first five years. Since the gross rate on such loans was 25 percent, this leaves a net rate of 21 percent. Repayments (not just the interest) on such loans were further eligible for a tax credit of 20 percent, which reduced the effective rate to 16 percent, almost as low as the inflation and deposit rates. Thus, despite a low real rate, only 11 percent of the roughly 25,000 purchases of new homes in 1998 used such a loan.[13]

The market for existing houses and renovations exhibits equally striking statistics. At a full market rate of 25-26 percent (a real rate of 10-12 percent, partly due to the monopoly pricing of the savings bank), only 4,500 buyers of existing homes (no more than 10 percent of the total) took out a loan (other than some deeply subsidized ones). Loans for renovations declined to less than 5,000 in 1998 from the 71,000 in 1993, even though the amount of renovation activity probably increased.

The Czech Republic has a similar situation. Its three active lenders are helped by three major subsidies: (1) a 4 percent buydown for 20 years for new housing, (2) tax-deductibility for mortgage interest, and (3) tax-exemption of profits from the mortgage business—as well as by the fact that nominal and real interest rates are substantially lower than in Hungary. As a result, spreads are lower on mortgage loans

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[12] In addition, thousands of households received "loans" at zero interest rate from their employers or local governments. Since these were effectively grants, they are not included in these figures.

[13] The figure of 25,000 units is an estimate. Actual recorded completions of new homes was only 20,300, because many of those building homes delayed completion in anticipation of being eligible for a new subsidy. It is not clear whether the public expected that completion date, start date, or purchase date would determine eligibility. In any case, even at 20,300 potential loan recipients, loan use was less than 14 percent.

and the after-subsidy real rates for buyers of new homes are close to zero. Moreover, because nominal rates stayed below 15 percent, dropping to 10 percent in 1999, maximum loan amounts have been reasonably large. Despite these nearly ideal circumstances, between 1996 and 1998 only about 1,900 loans per year were originated by all banks for new housing—financing 2,500 units (many family houses have more than one unit) or not more than 15 percent of new home buyers.

Slovakia has had relatively low real lending rates, but no subsidies to push them into being negative. Lending, restarted in 1995, was at first popular for renovations but has languished since 1996, when the real rate rose from 4 percent to 5.5 percent and subsidized competition by building societies and the State Housing Fund began. In 1997, only about 950 loans were made for both new and existing housing, in a potential market of at least 20,000 housing transactions. (This is expected to change now that a 6 percent subsidy to mortgage loans has been adopted.)

Poland presents a somewhat different picture. There are no finance-related subsidies at all, tax or otherwise, and competition has been active for several years. Real lending rates appear to have been in the range of 10 percent, which reflects a higher real rate on government-debt as well as high margins. The spread over deposit rates appears to have been about 6-7 percent, lower than in Hungary, possibly due to the greater competition. No reliable data exists on lending volumes or even on the level of housing activity to be financed. But informed observers estimate that about 30,000 loans were made in 1998 for home purchase, of which up to an estimated 15,000 were for new housing. Since 70,000-80,000 new units were probably subject to financing, the overall use rate appears to be about 20 percent, distinctly higher than in Hungary.

The higher loan use rate in Poland is a new phenomenon, reflecting a compound rate of annual increase in real lending of over 30 percent since 1995. This could be because of the better economic experience of Poles or different attitudes toward the use of credit. But the most likely explanation is the aggressive marketing that has appeared as part of the active competition of Polish commercial banks. Despite this success in expanding the market, however, loan use still greatly lags that in advanced countries such as France, Germany, and the U.K.

Table 1-3 summarizes the use rates for market-rate finance in the four countries and the explicit effective costs of borrowing. Except for Poland, such loans are used in fewer than 15 percent of actual transactions and the use rate does not appear sensitive to the real cost.

TABLE 1-3
USE OF PRIVATE HOUSING CREDIT, 1998

Country	Housing Use	Effective Real Rate (%)	Spread over Deposit Rate (%)	Share of Potential Market (%)
Czech Republic	New	0	0-2	< 15
Hungary	New	1	2	< 15
Hungary	All Other	10	11	< 10
Poland	New	10	6	20
Slovakia	All	5	4	< 10

High Real Rates, Reluctant Lenders, or Reluctant Borrowers?

With use rates such as these, one could conclude that development of a better housing finance system has not had, and perhaps will not soon have, significant effects on the functioning of the housing sector. This makes it important to ask why use rates are so low.

The author posed this question to observers in each country. The common view in Hungary and Poland was that the relatively high real interest rates have discouraged borrowing. In Hungary, for example, inflation has declined more than interest rates, thus opening up a spread of about 10 percent between inflation and rates charged by the largest lender (including servicing fees). These punitively high real interest rates may seem a good reason why fewer than 1 in 10 buyers of an existing home take out a loan. However, this is more of a reason to borrow less than to not borrow at all.

In Slovakia and the Czech Republic, although real and nominal rates have been much lower, loan use has not been much higher. In 1998, the common perception in both seemed to be that the public was put off by the presence of rates much higher than the 1-3 percent previously charged and that market rates will have to come down to below 10 percent to arouse interest. However, rates in the Czech Republic are now near 10 percent and regular mortgage lending has still not grown significantly. (In contrast, over 100,000 loans will be made by Bausparkassen at an effective after-tax rate of 4.5 percent.)

A common explanation given in all four countries is that high inflation has kept nominal interest rates so high that the amount that can be borrowed is quite limited. However, this cannot have been much of an issue in the Czech Republic and Slovakia, because mortgage rates were only 11-12 percent in 1995-1996. Similarly, the public in Hungary has not generally accepted the option of taking out loans that mimic those in lower-inflation countries (i.e., loans that reduce the short-term loan repayment burden by deferring a part of the repayment). Poles, in contrast, have made heavy use of some amount of deferral, perhaps because they have understood it better due to their period of hyperinflation.

In both the high-interest and lower-interest countries, lenders are perceived as skeptical enough about the "politics" of loan enforcement (irrespective of the legal and procedural situation) that they are being conservative in underwriting and pricing housing loans. This introduces the possibility that the lenders are employing non-price rationing or other screening devices that are cutting down on the number of households who are eligible. Is it the reluctance of the lenders, either instead of or in addition to the borrower's price sensitivity, that is really slowing the growth in housing finance?

The evidence seems to contradict all these explanations. Even if households are naturally reluctant to borrow at high real rates, subsidizing real rates to much lower (but still positive) levels does not increase demand by much. Moreover, households *will* borrow when the loans convey a net cash subsidy (as in Hungary in 1993 and a variety of low-rate loan programs today); and banks are willing to make loans when people are willing to take them (competition seems to be fairly intense).

The only consistent explanation across all the experience within the region is that Central Europeans are averse to borrowing for housing unless the act of borrowing conveys a grant element. Credit use is low in all countries and among all sub-categories of borrowers, even in the face of subsidies reducing the effective real rate to relatively low levels—unless credit is subsidized enough that borrowers can actually make money by taking credit (e.g., loans from Bausparkassen). There is little evidence that lender reluctance, while perhaps quite strong, is the decisive element.

Why Are Households So Reluctant to Borrow?

One useful way of recasting this question is to ask how the great majority of homebuyers can buy without using any private-sector long-term credits.[14] To this analyst, the operative reasons have to do with aspects of demography and real estate markets that are unique to Central Europe. First, populations are growing slowly or actually declining, though with some trend towards net growth in number of households. This implies that, on average, only one descendant household enters the housing market for every household leaving it (through moving in with children or death).[15]

Second, most households are either *de jure* or *de facto* home owners. Even tenants in Central Europe have effective occupancy rights, rights which are valuable because rent levels do not cover any capital recovery and sometimes not even regular

[14] Some buyers of new homes are receiving grants (Hungary), tax savings (Poland), or low-rate state loans (Czech and Slovak Republics). But even these supports would leave at least half of the cost to be covered in other ways.

[15] This situation does not mean that the arrival of each new household will be matched by the departure of a household composed of ancestors of those specific people. But the decline in birth rates over the last generation makes it likely that most new households will involve descendants who have some significant claim on the housing equity of a household already ceased, or about to cease, existence. And in these countries, the tradition is to pass that equity on to the next generation, not to consume it.

maintenance. This situation deters them from moving if these rights are not very salable, or gives them a significant cash equity stake in their unit if the rights are salable.

Third, whatever debt was taken on to acquire that current unit has been practically eliminated since 1988 through inflation. Putting these three conditions together implies that a very high percentage of would-be buyers in Central Europe have access to significant cash resources for housing purchase, either from their current unit or from the unit of their genealogical forebears.[16] Of course, not all would-be buyers are this fortunate. The disadvantaged group includes young couples without access to parental or grandparental home equity and those living in very low-value (or illiquid) units at the time "socialist" property was generally allocated to the current user. These households could be a significant group among those who do use credit. In addition, there are those, especially the newly upwardly mobile professionals, who want to supplement their cash position to buy a better house (Czech lenders report that these are major customers).

But this explanation still leaves an important mystery: Why do not more households, whatever their cash position, use at least some market-rate credit to enhance their ability to afford an even nicer house? Few households borrow even a thousand dollars more to supplement their initial cash stake. Standard economic theory would suggest that, in the absence of major fixed transactions costs or wealth levels that exceed the cost of a pretty luxurious house, most households would use the opportunity to borrow based on their future income to expand their consumption of long-lived consumer durables.

An *ad hoc* but attractive possibility is that Central European households have not (yet) fully embraced the consumerist ethic of Western Europe and the U.S.—at least not sufficiently to pay any significant effective price in consumer credit for "truly discretionary" spending. A variation on this theme is that whatever discretionary borrowing they might want to pursue is being pre-empted by purchases of other long-denied consumer durables, especially automobiles.[17] Observers in Poland and Hungary, for example, have noted a willingness to take on large debt burdens to buy a car that can actually cost more than a house.[18] Poland's experience with consumers

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[16] In Hungary at least, this situation is reflected in an apparent tradition of better-off parents buying a flat for their children, perhaps from the proceeds of their parents' housing equity. Now that more than one flat can be owned, such activity is often being done in advance of the child living independently and such flats are a major source of a growing private rental market.

[17] It could be instructive to study how responsive the demand for car credits has been to changes in real rates and other terms of loans. This could indicate the potential for expanding lending to homebuyers as nominal and real rates decline.

[18] Marketing surveys in Hungary have found a willingness to pay 30 percent of income in car payments, but only 10 percent towards a housing loan. Another interesting finding: 70 percent say it is shameful to need a loan to buy a house.

responding to more intense marketing efforts strongly supports this version of “borrower [19]

Another type of "attitudinal" explanation is that households in Central Europe are not comfortable with spending the 25-30 percent of their current income on housing (usually not including utilities) commonly observed in market economies. Instead, they may perceive the proper allocation of current income for housing to be 10-20 percent, including utilities, leaving little room for debt service.[20] This may reflect a reluctance to abandon the notion that housing is something the state (or parents) should be heavily subsidizing.[21]

These attitudinal explanations imply a profound divergence from the presumptions underlying the promotion of housing finance in transition economies, where almost all calculations assume that households wish to borrow as much as they can, and that 25-35 percent is a reasonable effort ratio. If these explanations are correct (and they are supported by the empirical observation that those few who do borrow average a 15-20 percent effort ratio), they may be articulated by the public as "housing is unaffordable"—even though by developed country norms it may indeed be affordable, just not while maintaining the level of consumption of other things (cars, clothes, vacations, cigarettes) the culture now expects.

These explanations also suggest that a second process will be necessary before the housing and housing finance markets fully develop in Central Europe—a process of adapting expenditure patterns to true relative market prices. Support for this hypothesis can be seen in the strong political currents in all four countries towards introducing deep subsidies for new construction. It is also consistent with support of public subsidies to

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Hungarian households may also harbor a mistrust of banks after the rates on the pre-1989 low-rate loans were raised sharply. In all of these countries, rates are set unilaterally by the lender, not based on an index. In principal, the banks could arbitrarily raise rates. In practice, though, this de-linking has meant that banks raise and lower rates with a lag from market rates. Also, the strength of this mistrust factor must be doubted, since Hungarian households flocked to loans as long as the rates were below deposit rates, although still subject to arbitrary change.

[19] Another aspect of the consumer learning curve is the low-level of bank usage in general, and the need to draw consumers into formal financial structures. However, this absence of existing bank accounts can not be the major reason for low borrowing, since the shift to usage of financial accounts such as Bauspar savings accounts has been rapid when marketing and subsidies are combined.

[20] This is not necessarily inconsistent with the willingness to save a large amount out of regular income towards a house purchase and especially saving 100 percent of windfalls, a frequent practice in Central Europe.

[21] A slightly different perspective is that households are too insecure about their economic circumstances to commit to a large fixed payment out of their regular income (literally "mortgage their future") for increased housing consumption (but will for cars over a shorter timeframe). These same households will commit to repaying a large long-term loan as soon as it comes at a rate that is lower than that earned on their cash assets. But that does not nullify the possibility that such fears do affect borrowing by those who really do not have access to equivalent cash resources.

building societies, which allow households to borrow at low enough (below deposit) rates that replacing the use of some of their available savings with a building society loan makes sense.

What about the perception that an equal or greater part of the problem is reluctance by lenders to lend? In addition to its impact on lender margins, such a reluctance might take the form of lenders being unduly harsh in evaluating or processing would-be borrowers, presumably because of nagging concerns about the robustness of loan recovery mechanisms or managerial lethargy. Some concern about loan recovery seems appropriate, given the remaining holes in the net of rapid foreclosure, sale, and eviction.

To what extent lender reluctance is a major cause of low borrowing volumes is not known. There does not seem to be much anecdotal evidence of would-be borrowers being turned down, but they may be discouraged by perceptions of scrutiny and difficulty. Where reluctance to lend may have a great impact is in the absence of extensive marketing efforts of the type that have been a hallmark of all building-society roll-outs in Central Europe.[22] Such aggressive marketing requires a commitment by senior management to expanding mortgage lending on a mass scale, a commitment that is unlikely as long as loan recovery is perceived to be politically or legally problematic.

V. THE FUTURE OF HOUSING FINANCE IN CENTRAL EUROPE

One might expect, with their adoption of the German model of housing finance, that housing finance would develop in a manner similar to its development in Germany. This expectation is reinforced when one hears market participants in those countries (all but Poland) speak about how "households will soon be able to build on their building society loans with a mortgage bank loan and maybe even a commercial bank loan." To this analyst, however, the near-term prospects appear quite different.

Most importantly, the role of the building societies will probably be quite different from that of the Bausparkassen. In the classic German model, a loan from a Bausparkasse serves two purposes. First, it reflects successful completion of a reasonably long period of steady payments towards a housing goal, thereby promoting and confirming the creditworthiness of the borrower. Second, the state subsidy helps the borrower build a larger downpayment than would otherwise be the case, thus reducing the risks to lenders of a conventional loan. Moreover, the Bauspar loan itself takes second rank to a larger and longer-term loan from a mortgage bank or other

[22] There is some evidence from Poland that stronger competition among commercial banks leads to both easier approvals and more aggressive marketing that can change attitudes. Certainly, the benefits of competition and marketing have been evident in the rapid growth of the building societies in the other countries.

source, which supports the traditional mortgage bond structure based on first mortgages with low loan-to-value (LTV) ratios.

So far, signs are that the building societies in Central Europe will instead become the dominant lenders, and provide few if any social benefits, for reasons specific to the region.

First, until market interest rates come down to EU levels, most would-be Central European homebuyers will need access to at least 30 percent of the house price in cash (and generally more than 50 percent). This is actually not such a challenge for most, as noted, because of demographic trends in the region and generally high levels of housing equity. In any case, the implication is that, if much of this funding is already available four to six years ahead of the home purchase (from either the would-be buyer or a parent), it can be transferred steadily from an existing account into a building society account. In this case, commercial or mortgage banks will not learn much about the creditworthiness of their would-be borrowers. As a result, building societies may find their default rates on home purchase loans not that different from those on commercial bank loans, since their borrowers may also be subject to payment difficulties once all of their free cash is invested in their home.

Second, also because of the relatively high inflation and interest rates, the state premium is going primarily towards preserving the real value of the household's savings in the face of negative real rates of return on the saving contributions. This yields little extra accruing to household savings or downpayment capacity. In fact, the building societies are perceived by the public as being primarily a method of accessing a subsidized loan (with a rate almost as low as the pre-1989 system of subsidized loans), not as a source of additional downpayment.[23]

Even if a saver in a building society were able to build a larger downpayment, any such addition to the downpayment (including the savings and loan amounts) would not be large enough to lead to any meaningful reduction in loan-to-value ratios on conventional lending. This conclusion is based on the arithmetic of conventional lending in these countries. Housing prices average about five times as much as the incomes of households trying to buy houses or flats (not necessarily the average household)—only a bit higher than in Germany. But, with interest rates on conventional loans of at least 10 percent, and maximum acceptable payment-to-income ratios around 33 percent, the maximum most households can borrow is about three times their income, about 60 percent of the cost of the house they want to buy.[24] If the effective

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[23] The Czech system is currently offering high enough rates of return that the completed savings are somewhat larger than if saved in a bank. This could translate into at most an extra 5 percent higher share of house price covered by the downpayment.

[24] Not only are interest rates lower in Germany but also the lenders permit repayment burdens up to 40 percent or more in some cases.

minimum downpayment is already 40 percent, any increase in it will not reduce the credit risk of a loan.

Ironically, the presence of the building society system practically ensures that conventional loans will not exceed 20-30 percent LTVs in the near future. In most cases, if a household is paying off a maximum loan from a building society over five to eight years, this already involves 10-20 percent of household income. Thus, the repayment capacity of the household is so reduced that a LTV ratio of even 30 percent on a regular mortgage loan is unlikely to be reached when a large building society loan is also being taken out. As long as the maximum conventional loan is less than 50 percent of the cost of the house, no reduction in default risk on that loan is associated with a lower LTV ratio. Thus, the subsidized building society system yields no benefit to the functioning of the overall housing finance system.

A further aspect of this analysis is that the building society systems do not even expand the borrowing capacity of participants, because of the relatively short terms of their loans. A building society loan for five years (as in Hungary) at 6 percent has a repayment only 10 percent lower than that on a market rate loan for 15 years at 25 percent. A building society loan for 8 years in the Czech Republic has a payment burden 40 percent higher per crown than a regular loan at 10 percent for 20 years. The net result is a negligible gain in access to funding (despite the substantial subsidy on interest paid).

The final implication is that the building society operations will tend to keep loan volumes at mortgage or commercial banks relatively low. The capacity for, and interest in, taking on additional market-rate finance is limited in any case. Whatever capacity and interest there is will be met in most cases by the maximum building society loan for a husband-wife family (possibly adding in borrowing rights earned by parents or other close relatives).

The most likely remaining market for commercial or mortgage bank lending will be for higher income urban homebuyers, both because they have the capacity to borrow far more than the maximum building society amounts and because they will be wanting houses costing more than the housing equity of their parents or grandparents. The value made of such loans may be significant. But the number will be relatively small and probably not sufficient to support a very competitive market supply. If volumes are stifled in this manner, it will become even less likely that mortgage bond issuance will develop as a meaningful source of funding for housing (although it may become so for commercial real estate).

It is very likely that the nominal and real interest rates in the CE countries will come more into line with those in Western Europe sometime in the future. When that happens, loan affordability will expand, maximum LTV ratios will be utilized, and public policies that facilitate higher maximum LTV ratios will become more pertinent. If this

combines with expanded willingness of households to borrow for housing, these housing finance systems will tend towards the German model and perhaps even the German reality of formal segmentation but effective integration.

In the near-term, however, the housing finance systems of these Central European countries, with the exception of Poland, seem to be converging on models that share three major features:

(1) A building society system encompassing a large part of household savings, including much of the population, and generating large volumes of deeply subsidized small-to-medium sized housing loans.

(2) Commercial banks making relatively few but larger loans, primarily for new housing and primarily in urban areas.

(3) A very small role for the issuance of mortgage bonds, as long as the volume of lending by commercial banks, and the subsidies to mortgage bonds, are relatively small.

Is this an ideal arrangement for these countries? Or, would it be better if these countries relied more on commercial banks for housing finance at market rates, with less general subsidy of new housing and of building societies? The answer depends heavily on whether one sees the benefits of the building society system of housing finance as greater than its costs. This analyst considers the benefits from such a system as minimal and the costs largely a waste of resources. But the public's perception of the government role in housing has been supportive of such a subsidized and distorted system and it remains a politically popular way of subsidizing borrowing for housing. All savers feel they are getting a gift of extra interest for being "virtuous" about their saving. Most homeowners feel they are getting some help with the burden of maintaining their home. And the building society industry is aggressive in pursuing its legislative goals.

Even if there were some social benefits to the system, the question would still be whether it is an economically efficient way of subsidizing housing. The answer to this observer is unambiguously no, since the subsidies are not targeted according to need or social value of the housing-related expenditure, and this particular way of delivering these subsidies involves a large amount of administrative effort and middle-man profit.[25]

Poland seems likely to avoid the deep distortions created by the building societies elsewhere and should see conventional mortgage lending developing

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[25] This is not to deny that other countries do not indulge in inefficient housing subsidy schemes for the same reason. The prime example is the U.S., where the deduction for mortgage interest is generally condemned by economists and most policy analysts, but enshrined in the hearts of the public.

normally. If it can also avoid the imposition of subsidies and provisions that favor loans funded by mortgage bonds, it will have a relatively efficient and low-cost housing finance system.

It should be noted that all the CE countries except Hungary will have some major subsidy scheme for new "social rental" housing (rental in name but with owner-type occupancy rights to the subsidies), and all will have major subsidy schemes for new owner-occupied housing. The design of these schemes will probably continue to be unique to the politics and circumstances of the country in question.

VI. THE TRANSITION IN RUSSIA

That housing finance has developed at a different pace and in a different form in Russia is not surprising. State control did not begin to disappear until 1992 and the public and the political system started off much less comfortable and familiar with private financial market processes than those in Central Europe. Even so, the sector has made very significant progress. This has been possible, at least in part, simply because the political and banking system was more uncertain about how to proceed in this area and therefore more receptive to donor-funded advice and assistance.

Factors slowing the Russian transition include very poor macroeconomic performance, high inflation, high real interest rates, banking sector instability, limited privatization of the public housing stock (due to little real rent reform and lack of true condominium status), and lack of even basic legal infrastructure governing mortgage lending.

But several factors were also supportive of progress. Even amid falling real GDP, for example, large numbers of new professionals were earning relatively high incomes in the growing private sector. This was a potential market for lending and often in a position to service loans denominated in foreign currencies not subject to high inflation. In addition, one of the areas of greatest private sector development was banking, and many private banks wanted to develop a presence in the retail deposit and loan market. Last, a substantial corps of donor-funded (primarily USAID) providers of technical assistance were ready to assist both retail lenders and government policymakers in creating a functioning housing finance system.

The result as of 1999 is a legal infrastructure that provides for registration of mortgage liens (1997), foreclosure and eviction, at least in the absence of children (1998), a reasonably functional revised civil code (1995-6), and a law permitting private ownership of land in limited circumstances. Moreover, the government has set up a fledgling secondary market mechanism (1997) that can eventually serve as a conduit of funding into the sector.

Before all this happened, however, Russian banks were already attempting to develop the market in housing loans in a variety of ways. Initial lending began in 1993. In 1994, a number of banks began to originate loans to individuals for housing purchase as a regular practice, although usually solely to employees. Originating loans to the general public presented a more serious challenge. One common scheme ("rent to purchase") was based on delaying the transfer of ownership right to a unit occupied by its purchaser by virtue of a tenancy agreement until full repayment of the loan. Even such a "quasi-mortgage" was characterized by the short loan term (no more than one to two years), a high interest rate, and a variety of additional conditions. Client payments were calculated to cover the full cost of a unit by the end of the rent period, including maintenance cost, rent, and interest on a loan actually provided to the client in hidden form. Even with such an arrangement, the LTV ratios for these loans were 30 to 50 percent.

As the economic situation stabilized in 1996-7, new trends in the development of mortgage lending appeared. Loan terms became longer, with some banks making loans for five and even ten years. More active use was made of pledges to purchase housing rather than the common "rent-purchase" scheme. Experience had indicated that nonpayment on housing purchase loans was low and might be further reduced through use of prudent borrower qualification procedures, which made the "classic" mortgage contract possible.

Relatively recent approval of legal structures supportive of mortgage lending has finally opened the way for the "classic" scheme of residential mortgage lending. Introduction of such a scheme makes it possible to expand the lending term and create loans more subject to secondary market funding. Surprisingly, the financial crisis of August 1998 has prompted more commercial banks to expand their services in more stable segments of the financial market than government securities. Today, many consider retail residential mortgage lending as one of the most promising types of these activities. Commercial banks make loans characterized by LTV ratios of over 50 percent, an interest rate varying from 20 percent to 28 percent on loans denominated in US dollars, and repayment terms that are generally two to five years but can be up to ten years.

To provide a better funding environment, the government is seeking to build a secondary market funding mechanism. Called the Agency for Housing Mortgage Lending, it was established in 1997 as an open joint-stock company, with the state exercising control over its activities. The Agency is planning to purchase mortgage loans banks have extended to private clients for a term of 5-10 years. It will then issue securities, which will serve as a source of funds for the Agency and also carry the guarantee of the Russian government and/or governments of the Federation subjects. (The Agency has so far bought some loans with its capital.)

The Agency is planning to issue two types of securities. One is general obligation bonds, whose issuance is regulated by the effective Russian legislation. The other is mortgage-backed securities. Issuance of such securities will not be feasible without development of proper legislative and regulatory framework and investors' interest in the purchase of new financial instruments.

For both types of securities, the risk of loan default will be borne by the bank originating the loan, through a required buy-back of any defaulted loans. This arrangement still leaves the government exposed to the substantial risk that the banks will fail. So far, banks have been funding their operations out of equity capital. It is yet to be seen how the bond market will value bond issues and whether market-rate bond funding will be attractive to lenders.

In addition to continuing major support for additional low-quality public housing units, Russia has pursued some well-designed, if underfunded, demand-side subsidy schemes. The chief alternative to the municipal construction program has been a lump-sum (up-front) subsidy scheme operated at both municipal and federation levels. This way of subsidizing home purchase in the market is currently being used by many Russian cities, although the volumes of such subsidies remain small.

The general goal of the lump-sum subsidy scheme is to more efficiently and effectively provide units to those who have been a long time on the waiting list for a "free" unit.[26] The subsidy amount ranges from 5 to 70 percent of the average market price of housing meeting the social standard for a given household, with higher amounts payable to lower income households and those who have spent more time on the waiting list. The subsidy, together with personal resources and a mortgage loan, can be used to buy any newly constructed or already existing unit on the market.

Political dynamics have also created another demand-side subsidy—an inefficient indirect subsidy scheme through the tax system. The largest component is a deduction from income tax up to three years for unit purchase or housing construction. The scheme also covers loan service. The maximum deduction was raised in 1995 to 5,000 minimum monthly wages (US$ 60,000) as measured by the exchange rate at the beginning of 1995. The revenue losses from this have probably been running at 2-3 percent of the Federation budget since then, with the largest subsidies, of course, going to those in the highest tax brackets buying the more expensive houses. It is notable that, even though purchases of existing units are also covered, the overall effect of the provision is to shift the tax burden to lower income groups.

[26] The greatest amount of use of this approach is being made by the Federation government to house retiring military officers.

After accounting for its later start and a much worse overall macroeconomic and political performance,[27] Russia's transition in housing finance is similar in many ways to that in Central Europe. After much struggle, a workable legal infrastructure has been provided to lenders, allowing them to pursue strategies for developing this sector in ways similar to those of lenders in Central Europe.[28] The market has developed so far without serious distortion (except perhaps for the dominant position of the state savings bank in the retail market) and appears ready for expansion when economic conditions improve. Funding flows may also be facilitated by a new secondary market window (but only at the cost of significant contingent liabilities to the government).

One additional factor that may limit consumer demand in Russia is the personal economic volatility since 1991. The recent drastic fall in personal incomes caused by the August 1998 crisis, and a second major loss or significant devaluation of individual bank deposits (the first coincided with the 1992 price liberalization) may be distinct disincentives for the public to make long-term financial and economic decisions until more stability appears likely.

VII. LESSONS FOR OTHER TRANSITION COUNTRIES

A number of European and Central Asian countries are at earlier stages in their transition to Western-style market economies. Each has its special history and circumstances, so generalization from Central Europe must be done carefully. However, the extensive and similar experiences in these four Central European countries suggest some tentative lessons.

Facilitating development of market-rate housing finance will not have immediate macroeconomic benefits, simply because few people will use it. Put simply, getting lenders to want to lend is not enough; the public must want to borrow. (The major exception to public reluctance to borrow is when loans are subsidized so deeply that they convey a net grant element.)

Borrowing at positive net cost is a habit that must be learned. The learning curve will start out very low, given the past history in these countries of housing having a very low share of household expenditures. Moreover, most populaces must also get used to a huge increase in housing-related utilities before extending an even larger share of their budget for debt service.

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[27] These have resulted in levels of lending activity being much lower than those experienced anywhere in Central Europe.

[28] However, the solidity of this legal structure is still less than in Central Europe. The mortgage and tax legislation, as well as statutory acts governing the banking sector operations both at primary and secondary mortgage market, still have serious gaps, including an adequate regulatory framework for foreclosure on mortgaged property and eviction of households of defaulted borrowers who have children in residence.

The significant social and economic benefits of widespread use of housing finance can be attained quickly in the middle and later stages of transition if proper supply-side preparations have been made. Preliminary evidence strongly indicates that, if lenders are ready to educate the public, the public will listen. Reform and development of housing finance is needed early on in the transition process to prepare for this outcome.

The enthusiasm of lenders (as well as their required margin) will depend on the presence of an adequate legal and financial infrastructure for mortgage finance. Banks and regulators face a steep learning curve as well; this is an area where donor-funded technical assistance has probably been very important.

Development of a properly competitive and sound banking sector generally is essential. It not only tends to cause margins to shrink, but banks also start paying more attention to the retail lending market when easy money cannot be made any other way and they become intent on pursuing long-term growth strategies.

It is notable that, once banks perceive the consumer loan market, including housing, to be a worthy target, finer points with respect to ease of loan recovery do not seem to deter their entry. As elsewhere in Western Europe, lenders may tolerate a relatively low degree of robustness in the loan recovery process in return for gaining a good position in the retail market.

A continuing government role in bank ownership can distort market development in several ways. Government-influenced banks may fix loan rates "too low" to be commercially attractive, and then ration access to minimize the damage. Borrowers may perceive that such banks are not free to aggressively pursue loan recovery. At the opposite extreme, consolidation of the monopoly position of the former state savings bank may permit charging rates that are "too high," similarly stunting the market.

Subsidies can help or hinder market development. Deep loan subsidies seem to encourage large amounts of lending associated primarily with taking out loans in order to substitute for other funds that earn a higher return. Such lending activity can encourage more lenders to enter the market, but only if the subsidies are channeled through conventional lenders. Moreover, such subsidized lending may not acclimate the public to borrowing at unsubsidized rates.

Notably, there is little evidence that shallow loan subsidies (e.g., tax-deductibility of interest) have much of an impact on lending volumes, at least in the earlier stages of market development. Common sense suggests that such subsidies should have some impact, but that impact may be overshadowed by need for a larger acculturation process to borrowing at positive cost. Notably, the two markets with the most activity,

Poland and Estonia, have no shallow subsidies (but do have supportive macroeconomic conditions).

Not surprisingly, deep subsidies through other channels undermine the development of market-rate lending. The low-rate government loans made in the Czech and Slovak Republics have almost certainly stunted demand for regular loans. The large lump-sum grants in Hungary after 1994 also smothered the need for credit to complete most new houses.

Evidence is overwhelming that Bausparkasse schemes are very inefficient uses of public resources. The outstanding question is not whether the benefits are worth the cost, but whether there are any benefits at all. Evidence on this point should be available soon, from Slovakia and the Czech Republic, in which hundreds of thousands of building society loans are now being made for "housing purposes." Some of these loans will substitute for market-rate loans. Others will be taken only to earn the arbitrage between the net cost of the loan and the return on alternative investments. Some may actually influence housing decisions, perhaps encouraging renovation or purchase of a more expensive unit. Even if it is not possible to discern much hard evidence on these issues, reports on public perceptions may be useful.

The track record of the Bausparkasse movement in these countries already offers a number of lessons for others. As concluded by Lea and Renaud (1994), such systems are inappropriate for high-inflation countries, where the bulk of the subsidy is going towards offsetting inflation, and the net rewards for saving in the system relative to in a bank are very dependent on the course of inflation during the contract period.[29] Moreover, the fears that these systems could be very expensive, and that the budget burden would be politically difficult to manage, have been confirmed. The situation in the Czech Republic, where the annual bonus has been untouchable while market interest rates have plummeted, points up the extreme impacts that are possible. Reports from Hungary and Slovakia indicate that any decline in new contracts prompts immediate pressure to boost subsidies further, confirming the expectation that the inherently unstable structure of the systems distorts political decisions about what form housing subsidies should take.

The usefulness of specialized mortgage banks and secondary market mechanisms in these countries is an unresolved question. Experience so far supports the view that neither offers advantages over deposit-based funding through commercial banks, at least when lending volumes are relatively small. Slovakia and the Czech Republic have found that bond funding is only attractive with substantial subsidy and is not needed to fund the level of demand experienced so far. Specialized mortgage banks in Hungary and Poland have played a negligible role so far and appear to be

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[29] Lea, M.J., and B. Renaud, Contract Savings for Housing: Suitability to TSE Financial Reforms, November, 1994, World Bank.

waiting for subsidies or other market advantages to expand (the mortgage bank in Hungary was given subsidies in 1999). Most importantly, there is no evidence to support the creation of mortgage banks as specialized banks (Hungary), in contrast to the universal banks with the capacity for mortgage bond issuance (Czech Republic). Neither is there any evidence that, in the absence of a government guarantee, funding through a secondary market institution offers any advantages over funding through deposits or mortgage-backed bank bonds.

How to promote housing finance when inflation remains high is another difficult question. *Developing the foundations of housing finance in anticipation of lower inflation is clearly worthwhile since development takes years. But experience with neutralizing inflation meanwhile through various "inflation-neutral" mortgage designs has been mixed.* Croatia and Estonia have had good results with foreign currency loans. Hungary and Russia have had less success with special loan designs, partly because of it was difficult to explain how they worked. However, if inflation-adjustments (such as in Poland) or foreign currency use becomes common in an economy, such loans are more likely to become acceptable.

ANNEX TO CHAPTER I

SUBSIDIES RELATED TO HOUSING FINANCE IN CENTRAL EUROPE AND RUSSIA

BUILDING SOCIETIES

Table A-1 summarizes the parameters of the Building Society (*Bausparkasse*) systems in the Czech Republic, Hungary, and Slovakia. (The distinctive system in Poland is being revised and has so far received low acceptance.) It also reports on their experiences with respect to participation, savings, loans, and cost. The bonus and rate of return data are for 1999, but the data on cost and participation is through 1998.

TABLE A-1
OPERATION OF *BAUSPARKASSE* SYSTEMS IN CENTRAL EUROPE

	CZECH REPUBLIC	HUNGARY	SLOVAKIA
Year of Initiation	1993	1997	1992
	1999 Data		
% Bonus	25 %	30 %	30 %[a]
Minimum Years to Withdrawal of Bonus	5	4	6
Minimum Years to: 6% Loan Bridge Loan	 5 2	 4 2	 6 2
Housing Purpose Req.?: For Bonus For Loan	 None Yes	 Yes, until 8 years Yes	 None Yes
Savings for Max. Bonus	US$ 515/Year	US$ 510/Year	US$ 500/Year
Max. Savings and Loan for Couple	US$ 14,250	US$ 10,500	US$ 12,500
Effective Rate on Savings	12-13 % tax-free	16 % tax-free[b]	11 % tax free[c]
Market Rate on Savings	8-10 % taxable	10-12 % tax-free	10-12 % taxable
Rate On Loans	6 % tax-deductible	6 % non-deductible	6 % non-deductible
Market Rate on Loans	10-11 % tax deductible	21-22 % partially deductible	14 % non-deductible
	1998 Data		
Net Contracts	2,400,000	350,000	920,000
Net Savings (Mil. USD)	2,563	138	1,160
Net Loans (Mil. USD)[d]	778	0	176
# of Loans	191,100	0	61,000
State Premiums (Mil. USD)	160	19	100
Premiums/State Budget	0.9 %	0.1 %	1.3 %
Premiums/Housing Budget[e]	54 %	19 %	46 %

Notes:
a Bonus had been 40 % prior to 1997.
b Return was 18 percent for contracts started in 1997.
c Return was 13 percent prior to 1997.
d These include only loans to customers, not loans to other parties.

e This is for 1999. 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.

The similarity across countries is notable. All three offer a maximum bonus for savings of about US$ 510 per year. If both partners in a couple start optimal contracts, they will be able to take out in savings and in loans an amount (at current exchange rates) around US$ 10,000-15,000 after four to six years (actually, these US$ amounts may be substantially less in four to six years because of future inflation). And all three require that loans be spent for housing purposes (this was not the case earlier).

The programs started out very strongly in all three countries, but subsequent experience differed. Strong growth has continued in the Czech Republic, with 2.7 million contracts expected to be outstanding in 1999 (almost 50 percent of the number of persons between the ages of 20 and 60). As of the end of 1998, 191,000 (only 8.6 percent of total contracts) loans had been made, at an average of about US$ 4,000 each.

Slovakia has experienced a slowdown in net contract growth, and seems to have peaked at less than one 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) in 1997 bonuses were reduced and a housing purpose was required for new contracts to get the bonus, even after six years. (The latter shift was reversed in 1998.) Even so, Slovakia has experienced the greatest burden on its budget, peaking at 1.5 percent in 1996. This was because its bonus (40 percent until 1997) was extraordinarily large.

Hungary had the unusual experience of a sharp slowdown in growth in the system's second year. This was primarily because a provision in the initial law cut the first year bonus from 40 percent for contracts started in 1997 to 30 percent for later contracts (enacted because of an expected decline in market interest rates). The result was many more contracts than might have been expected in 1997, since most people wanting to start a contract in the first two years faced a large incentive not to wait until 1998. Rapid growth has returned in 1999.

SUPPORTS FOR CONSTRUCTION OF NEW OWNER-OCCUPIED HOUSING

Czech Republic

In 1996, the government created three significant subsidies for residential loans taken out with mortgage banks (which are part of ordinary commercial banks) for new construction. A 4 percentage point buy-down from the market interest rate was granted for up to 20 years, paid directly to the lender on a limited (but with a high limit) loan

amount. In addition, government debt became fully taxable after 1996, while mortgage bonds remained tax-exempt. Mortgage banking activities of commercial banks are tax-free.

The latest subsidy, which is specific to new construction and started in July 1997, is a special loan offered by the government, designed to complement loans made by mortgage banks and building societies. The loan, which is limited to CZK 200,000, is interest-free and for 20 years—but 10 years grace on repayment makes it essentially a grant.

In addition, the Czech Republic enacted a tax deduction for mortgage interest that is applicable to mortgages (and now Bauspar loans) on new or existing housing. Since tax rates range from 15-40 percent, this deduction can be quite valuable and pushes the effective cost of borrowing to less than the rate of inflation (but not necessarily less than the after-tax rate on bank deposits).

Hungary

Hungary is the only Central European country to have a tradition and current practice of offering lump-sum, cash subsidies for new housing construction. From 1971-1994, this subsidy was called the Social Policy Allowance (SPA), to highlight its connection to population growth policy. Receipt of any subsidy had always required the presence of at least one child. This was considered an extension of population policy because it provided extra amounts for a second and third child.

In late 1994, the subsidy's name was changed to Housing Construction Allowance (HCA) and it was restyled as a counter-cyclical subsidy to boost housing construction. The HCA for two children was raised from HUF 300,000 to HUF 1.2 million and for three children from HUF 900,000 to HUF 2.2 million. The new amounts translated into US$ 10,000 and US$ 18,000, respectively, as of early 1995.

Between 1993 and 1995, the cost of the subsidy jumped from 0.3 percent of the total budget to 2.0 percent. Housing activity increased rapidly (permits jumped, there are no data on starts) and completions in 1996 were 34 percent higher than in 1994.[30] Eligibility for the HCA was tightened in May 1995 and its nominal amount has not increased since 1994. In 1998, for the first time since 1995, its cost fell to less than 1 percent of the budget.

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[30] In principle, this expansion in activity might have been accompanied by an expansion in lending, despite the larger lump-sum subsidy. Quite to the contrary, since the HCA was introduced, the real amount of bank lending has shriveled. In 1997, no more than 2 percent of the total cost of new housing was financed by a bank loan, while the HCA covered about 12 percent overall.

In addition to the HCA, Hungary has a subsidy of a 4 percent buydown of interest due for the years 1-5, followed by 3 percent for the years 6-10, and 1 percent for years 11-15. The maximum amount that can benefit from the subsidy is HUF 1.2 million, more than most borrowers take out. Loans eligible for the 4-3-1 subsidy are also eligible for a tax subsidy, through a provision called the Housing Loan Repayment Credit. This subsidy takes the form of a 20 percent credit rather than the open-ended deduction at higher tax rates. The credit has a maximum of HUF 35,000 per taxpayer, making the maximum benefit available only for repayments of HUF 175,000. Most loans do not reach this level; the average claim in 1995 was only HUF 15,000. However, the subsidy does create a significant reduction in the after-tax cost of mortgage borrowing. At an interest rate of 22 percent (1999), a loan term of 10 years, and a loan of average size, this provision combined with the 4-3-1 subsidy results in an effective repayment reduction equal to an interest rate of only 12 percent (approximately zero real interest).[31]

In 1998, the new government followed up on campaign promises by reinstituting a special exemption of HUF 400,000 from the VAT tax on new housing. This acts as a lump sum grant of about US$ 1,700 (1999) for most builders of new houses.

Poland

A major tax subsidy for new construction was put in place in 1992, just as the costly effort supporting co-operative construction was ended. The original provision allowed taxpayers to deduct from their taxable income construction costs for up to 70 square meters. This provision translated into a ceiling amount that has been indexed since then to the average cost of construction as officially estimated. For 1998, this amount was PLN 101,000 (US$ 29,000).

Since the costs of nearly all new units exceed this amount, the subsidy scheme has become a lump sum deduction for all of those acquiring a new home. Originally the actual value of the subsidy depended on the tax bracket of the household, which could vary from 15 percent to 44 percent, with greater subsidies going to higher income households. This provision was reformed in 1997 to specify a fixed bracket of 19 percent to be applied to these deductions. This converted the subsidy to a credit against taxes due rather than a deduction against taxable income.

Russia

The largest subsidy is the deduction from income tax for a period of up to three years of the cost of unit purchase or housing construction and loan service. In the first half of 1998, the maximum deduction was 417,000 rubles (about US$ 65,000) but the

[31] Notably, neither these subsidies nor the one in the Czech Republic have seemed to be deep enough the provoke large-scale borrowing in the face of even modest real market interest rates

dramatic fall of the ruble by December of 1998 reduced it US$ 20,000. These subsidies are granted not only for new but also for existing housing.

Another, much smaller subsidy, also applicable to existing as well as new housing, is an up-front lump-sum grant offered by certain localities and for special groups by the Federation. The grant can cover up to 70 percent of the cost of a very small unit.

Some income from housing sales is also exempted from income tax. Since 1994, amounts received from the sale of residential units, family houses, or land plots are exempt if they do not exceed 5,000 minimum wages (near US$ 20,000 at the ruble exchange rate of the second half of 1998).

Another type of indirect subsidy of housing sector is a reduced VAT rate for construction companies involved in new housing construction projects with more than a 40 percent share of state participation. (This provision does not apply to individuals).

Slovakia

In 1996, a structure called the State Housing Fund was created, under which the typical subsidy provided includes a grant portion of Sk. 150,000 and a loan of Sk. 500,000, for a total financing package of Sk. 650,000 (at that time about US$ 20,000). The term of the loan is 30 years and the interest rate is generally 1 percent. Such an amount is about half the cost of a modest new flat (60 sm., at Sk. 20-25,000 per sm.), but slightly less than one-third of the cost of a new family house or larger flat.

In the Fund's first year, only Sk. 800 million was actually disbursed. In 1997, disbursements jumped to Sk. 1.7 billion and in 1998 to Sk. 3.5 billion. Only about Sk. 1 billion of the funding for the SHF actually comes from the government budget. The rest comes from low-rate bonds sold by the Fund to the building societies or contributions from the National Privatization Fund. It is unclear how sustainable this rate of funding is.

In contrast to the Czech Republic, Slovakia at the moment has only one mortgage banking subsidy, the ability to issue bonds that are exempt from the 15 percent withholding tax. This applies whether the funds are used for new or existing housing or commercial real estate. However, no such bonds have been issued yet and new subsidies are being sought to promote bond issuance. Specifically, an interest subsidy of 6 percent is expected to be added in 1999.

SUPPORT FOR THE PURCHASE OF EXISTING HOUSING

Czech Republic

Several of the subsidies applicable to new home construction can also benefit the purchase of existing housing, including the tax deduction for mortgage interest, the tax-exemption of mortgage bonds, and the tax exemption of mortgage banks.

Hungary

Hungary has no subsidies applicable to the purchase of existing housing.

Poland

Poland has no subsidies applicable to the purchase of existing housing.

Russia

Some of the subsidies applicable to the construction of a new home can also apply to the purchase of existing housing. These include the tax deduction for housing expenditure and mortgage service and the use of lump-sum grants.

Slovakia

Slovakia has no subsidies applicable to the purchase of existing housing, other than the tax-exemption of mortgage bonds. A new mortgage loan subsidy of 6 percent is pending.

SUPPORT FOR CONSTRUCTION OF NEW RENTAL FLATS

Czech Republic

Starting in 1995, the central government sought to revive municipal construction of flats with a new direct subsidy program. Municipalities became eligible for a grant of up to CZK 320,000 towards construction costs, and another CZK 50,000 towards technical infrastructure, for a total of CZK 370,000—about one-third of the total cost of building a modest size new flat (US$ 30,000-40,000).

The municipality must fund the remaining amount, including in-kind contributions of land and infrastructure. It usually does this through some combination of commercial loan (often secured by some municipal property) and "pre-payment" of "rents". This last amount can apparently be up to one-third of the cost; in return, the tenants are not required to pay any "rent" (but still pay for maintenance and services) for the first 10-20

years. There may be a provision whereby, after 20 years, ownership of the property passes over to the tenants.

In its initial year (1995), about 7,500 units received commitments for this subsidy. In its second year (1996) another 4,700 units received commitments for before funds were exhausted. As of 1997, another 11,500 units were awaiting approval, of which 6,500 were funded, and funding for 7,800 was approved for 1998. The 1999 budget will boost the number approved for funding to 9,000.

Hungary

Hungary has no subsidies for construction of rental housing.

Poland

Poland has a major new subsidy program to expand the supply of below-market rental housing. Known as the TBS system, it is built around the notion of non-profit entities (TBSs), which include local governments taking responsibility for constructing, owning, and managing blocks of rental units. In return, the TBSs get a significant capital subsidy (a loan from the government for 70 percent of the capital costs at only half the bank rediscount rate) as well as some equity investment from the tenants, without having to put up any equity itself. It must then operate under the burden of rents set no higher than 4 percent of "replacement cost".

The tax deduction for investment in new housing is also available for use by individuals building new rental housing.

Russia

Despite the end of the old socialist housing system, one of the major forms of housing subsidies is still direct financing of residential construction from federal and local budgets with allocation of new units to people from the “waiting lists”. Such construction has decreased by nearly 75 percent (from 1.3 million units in 1990 to 344,000 in 1998) since 1990, but it is still a significant share of production and the largest part of the housing subsidy pool, mostly from the Federation Government.

Slovakia

Since 1995, there has been a major effort to finish the construction of municipal rental flats that had been started but left unfinished in 1989. This has involved the "contribution" of Sk. 2 billion from the resources of the National Privatization Fund, sufficient to finish about 1,500-2,000 additional panel flats, and is a one-time effort. There has been extensive discussion of starting up some kind of non-profit social housing sector but no definite plans have been made at this point. However, some

State Housing Fund resources are apparently being diverted to support new municipal construction of rental housing.

CHAPTER 2

CZECH REPUBLIC

Population: 10.3 million (1995)
GDP: CZK 1.7 trillion (1998)
State Budget: CZK 536 billion (1998)
Exchange rate: CZK 32/USD 1.0 (1998)

BACKGROUND

Housing Finance Under Communism

The Czech Republic was part of Czechoslovakia during the Communist period and shared with Slovakia, as well as with Poland, an emphasis first on state-owned rental flats and then on co-operatively owned and managed flats. However, throughout the socialist period, the possibility of obtaining an owner-occupied family house remained, if one could procure the land and building materials needed to complete it. As of 1990, the overall housing stock of 3.7 million units was distributed in the following manner:[32]

Housing Unit Status in 1990:

Owner-occupied:	
Family Houses:	40 %
Co-operatives:	19 %
Public Rental:	30 %
Other Rental (mostly employer):	10 %
Private Rental:	1 %

At that time, new housing was financed in several ways. State-owned or employer-owned units were still about a quarter of the starts just before the 1989 "revolution." But co-operatives were the principal form of new housing, especially in urban areas. Only one-third of their cost was financed directly by the state budget, another one-third by a cash contribution from the would-be residents, and the last one-

[32] Data are from Hegedus, J.; Tosics, I.; and Mayo, S., "Transition of the Housing Sector in the East Central European Countries," Review of Urban and Regional Development Studies, 8, 1996.

third by a loan to the co-operative by the state savings bank, for 40 years at a fixed interest rate of 1 percent.[33]

Owner-occupiers building family houses also had access to significant long-term financing from the state savings bank, at 2.7 percent also for 40 years. The maximum loan size was more than half the official cost of producing a family house. At the black-market cost of materials and labor, however, there was really more than half left to be met with sweat equity, cash savings, or remittances from émigré relatives abroad. Beyond the simple issue of funds were the extreme practical difficulties of executing a project in a system that was totally non-supportive.[34]

The below-market financing available from the state savings bank was financed through a combination of low interest rates on deposits (from a monopoly position) and cross-subsidization of loans to enterprises.

Initial Adjustments

From 1990 to 1995, several important adjustments were made in the housing and housing finance sectors. New legislation provided for the transfer of most state-owned stock to municipal governments, privatization of that stock to sitting tenants, and restitution of pre-war rental stock (with sitting tenants at controlled rents). By 1995, the end of state-supported construction and the privatization and restitution process had shifted tenure patterns somewhat. The new figures were:

Housing Unit Status in 1995:	
Owner-occupied:	
Family houses and flats:	43 %
Co-operatives:	20 %
Public Rental:	27 %
Private Rental:	10 %

Notably, the share of stock that is owner-occupied has not risen significantly despite the potential for privatization to sitting tenants. A major inhibiting factor until 1994 was very low and declining real rent levels, leaving little incentive to take over ownership of a municipal flat. Privatization received two boosts in 1994—with the start

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[33] The present value of the repayments on this below-market rate was about half the value of the loan. Together with the cash grant from the state, the total cost to the state of a co-op unit was about half the price of the unit, and thus half the cost of a municipal flat. Moreover, since the co-op residents, in contrast to tenants in state rentals, were expected to pay for the full costs of the maintenance of their buildings, as well as service the debt, the net present value of the cost to the state of building co-ops was actually less than half of that of adding more state rentals.

[34] The author experienced this through the letters of a Czech émigré friend who returned and attempted to build a family house in a medium-size town in the 1970s. It is notable that the construction of family houses was so low that their absolute number in the Czech Republic fell steadily from 1960 until 1991.

of a rent reform process and a new possibility for individual tenants to purchase their units (previously, the whole building had to be privatized for such purchases to occur). However, since local governments have been given complete leeway in setting privatization prices and have generally chosen to give relatively small discounts (20-30 percent) from estimated replacement cost, privatization will remain limited until rent levels approach free market levels.

New construction activity fell sharply after 1990, both because the traditional financing techniques had disappeared and because real interest rates were high and real economic growth negative. The data on recorded housing starts were distorted by a jump to 61,000 in 1990, in order to take advantage of the last of the old subsidies to construction of rentals and cooperatives, followed by an 88 percent decline to a low of 7,500 in 1993.[35] Completions declined far more gradually, bottoming out in 1995, 70 percent lower than in 1989.

TABLE 2-1
STARTS AND COMPLETIONS OF HOUSING UNITS: 1989-1998

YEAR	# Of Units Started (000)	# Of Units Completed (000)
1989	56.0	55.1
1990	61.0	44.6
1991	10.9	41.7
1992	8.4	36.4
1993	7.5	31.5
1994	11.0	18.2
1995	16.5	12.7
1996	22.7	14.5
1997	33.2	16.8
1998	35.0	22.2

Not all parts of the market were affected in the same manner (see Table 2-2). The decline in the cooperative share in completions reflects the end to new commitments of state funds after 1990. By 1998, that sector had practically disappeared. The same cutbacks were affecting construction of rental municipal units. But completions did not decline as rapidly or as far, initially because of the longer lag between commitments and executions in that program and more recently because of deep new subsidies to the sector. Notably, construction of privately owned units was not as strongly affected, since this part of the market was not initially so dependent on subsidized financing (and continued to get some subsidy) and was now better able to

[35] It is surprising how sharp this decline was, considering that the state persisted in offering low-rate finance for family houses through 1992.

get building materials. Moreover, a significant share of this private construction (about 8 percent) was now for private rental at market rents.

TABLE 2-2
COMPLETIONS OF HOUSING UNITS: 1991, 1994 and 1998

YEAR	Total	Municipal	Cooperative	Individual	Other
1991	41,719	9,610 (23%)	19,489 (47%)	10,426 (25%)	2,194 (5%)
1994	18,162	4,224 (23%)	5,601 (31%)	7,373 (41%)	964 (5%)
1998	22,183	3,216 (14%)	138 (1%)	18,829 (85%)	0 (0%)

As in the other CE countries, an immediate issue was the burden of subsidizing the outstanding low-rate loans on coops and family houses. The stock of old loans in 1997 was about US$ 800 million and the subsidy outlay was about US$ 120 million (0.8 percent of the state budget). This is a substantial burden, as is the case in all CE transition countries.

Macroeconomic Evolution

The Czech Republic was expected to be one of the first of the transition economies to begin to recover economically. This was because of the strength of the traditional ties with its neighbor, Germany, and also because of the strong private-market attitude and what was perceived to be an aggressive privatization program of its first post-Communist government.

The recession that immediately followed 1989 was less severe than in Poland and the recovery began almost as soon and as strongly, with real growth starting again by 1994-95 and hitting almost 7 percent in 1995. The economy stumbled again in 1997, however, under the weight of the failure of three banks and several scandals involving non-transparent dealings in publicly-held companies. Foreign investors lost confidence because of the "shallow" privatization process, leaving previous managers entrenched and weak corporate governance and access to foreign direct investment.

The slowdown continued through 1998 and into 1999. Deeper structural reforms are now awaited from the new government installed in July 1998. Meanwhile, the recovery in the new housing market has continued, fed by expanding subsidies and rising incomes in the top part of the distribution.

EVOLUTION OF HOUSING POLICY[36]

The first non-Communist government set out to convert the housing sector to free market operation by removing all explicit subsidies and encouraging the banking institutions to pursue private housing finance. The first step was to create the Ceska Sporitelna (CS) to take over all retail accounts in spring 1990.[37] CS inherited the retail housing lending activities of the prior state savings bank and, in theory, continued to offer housing loans at a variable nominal rate denominated in crowns. It initially limited the term of these loans to 6 years, however.

But the government did not take the necessary follow-up steps of forcing privatization of the existing rental stock and pushing rents toward market levels. This failure removed any incentive for the existing rental population to buy their units and reallocate the stock or sell and invest in new housing or for potential investors to invest in existing rental housing (except for new rental housing, which is exempt from rent controls).

In the short run, the situation of declining trend in housing investment was arrested by the stream of municipal and coop flats completed through 1994. However, faced with housing starts running at only 10 percent of their previous level, the government reversed course in 1993, and introduced the first of several deep subsidy programs aimed at sparking renewed housing construction activity.

The initial focus of these efforts was on housing finance. The first innovation was support for a system of building societies, modeled after the German and Austrian Bausparkassen.[38] With the government still officially non-supportive of such a move, strong lobbying on the part of foreign Bausparkasse interests was able to get Parliament to take up the subject directly. The resulting system was subsidized sufficiently that it has grown quite large, with about one-fourth of the population (estimated at close to 50 percent of the adult, non-pensioner population) participating by 1997. Its operations are discussed in detail below.

As the “building societies” were being introduced, the momentum for creating a system of mortgage banks also became stronger. Some of the basic legislation was

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[36] This section benefited from an article in *Housing Finance International*, by Eva Marikova Leeds, "The Development of the Mortgage Market in the Czech Republic," March 1996.

[37] In an illustration of the weaknesses of the overall Czech privatization scheme, CS was considered to be “private” because the state did not have direct control, since a controlling interest rested with the National Property Fund (the privatization entity). As a consequence, CS has been without the direction and dynamism that a strategic partner would have brought it. In June 1998, a major effort to press for true privatization of CS was being pursued by the EBRD, which acquired a 12 percent share to "encourage" government action.

[38] In Czech, the name of these institutions means "construction savings banks", but they prefer to be called "building societies" in English and that usage is adopted here.

enacted in 1990, further active discussion began in 1993, but the final mortgage banking legislation was not inaugurated until 1995. The delay is ascribed to technical issues involved in regulating the mortgage banks. Equally important, however, were disagreements between the Czech National Bank and the Ministry of Finance about whether to integrate the mortgage banks into the system of universal banks already in existence, and reluctance on the part of the Ministry of Finance to include major subsidies for loans made by mortgage banks. The resolution of these controversies is discussed below.

Introducing building societies and mortgage banks were two major steps towards further development of the private housing finance sector. However, as was soon apparent, their impact was not through the institutional structure per se, since all were closely associated with existing "mother" banks, but in the incentives and subsidies they set up. Neither initiative led to an immediate resurgence in construction, however. The incentives in the building society system were towards saving for the full five-year minimum period, although it was possible to take out a "bridge" loan after two years. And the loans from the mortgage banks still left borrowers paying a significant interest rate, even when eligible for subsidy, so households were in no hurry to borrow.

The central government then took more dramatic action to stimulate housing construction.[39] Starting in 1995, it sought to revive municipal construction of flats with a new direct subsidy program. This program makes municipalities eligible for a grant of up to CZK 320,000 towards construction costs, and another CZK 50,000 towards technical infrastructure, for a total of CZK 370,000, about one-third of the total cost of building a modest size new flat (US$ 30,000-40,000).[40]

Municipalities must fund the remaining amounts, including in-kind contributions of land and infrastructure. They usually do this through some combination of commercial loan, often secured by some municipal property, and "pre-payment" of "rents". Apparently, this last can amount to as much as one-third of the cost. In return, the tenants are allowed not to pay any monthly "rent" for the first 10-20 years (although they still pay for maintenance and services). Moreover, there may be a provision whereby, after 20 years, ownership of the property passes to the tenants.

This program, thus, provides up to a two-thirds subsidy towards eventual ownership of a modest flat. In its initial year (1995), about 7,500 units received commitments for this subsidy. In 1996, another 4,700 units received commitments before funds were exhausted. As of 1998, about 20,000 units were awaiting approval, of which 8,000 were funded in 1998 and funding for another 9,400 was approved for 1999.

[39] This shift was marked by the transfer of the administration of the mortgage banking and BS subsidies from the Ministry of Finance to the Ministry of Regional Development.

[40] This contribution towards infrastructure could be used for plots being developed by others as well.

In 1996, the government added two subsidies to residential loans taken from mortgage banks when used for new construction. A 4 percentage point buy-down from the market interest rate was granted, paid directly to the lender on a limited (but with a high limit) loan amount. In addition, government debt became fully taxable after 1996 while mortgage bonds remained tax-exempt. Despite these incentives, lending levels remained relatively low.

The latest subsidy to new construction, starting in July 1997, is a special loan being offered by the government, designed to complement loans being made by mortgage banks and building societies. The loan is interest-free and for 20 years, but a 10-year grace period on any repayment makes it essentially a grant. It is limited to CZK 200,000, but has proven very popular.

By 1994, before the effects of these stimuli had appeared, the general economic recovery had already prompted a 50 percent rebound in housing starts. The direct subsidy to municipal starts helped push total starts in 1995 to over twice their level in 1993. Economic growth and the subsidies again doubled starts (to 33,000) in 1997, a pace still 40 percent less than average activity in the 1980s but clearly much higher than if households had had to face the full cost of housing investments. Starts continued to increase in 1998, despite an overall economic slowdown.

Although the new construction sector has recovered, only limited progress has been made on "marketizing" the previous stock of municipal housing. In the aftermath of state-owned stock devolution to the municipalities, the central government retained the right to set maximum rents. In 1992, the Parliament enacted a plan for deregulating the rental sector by "around" the year 2000. The first step was an immediate 100 percent increase in the rent ceiling (after 25 years of being frozen). Since 1994, there has been a regular series of increases set at a certain amount over inflation, with a further allowance for the major cities.

Ceiling rents are still far from "market" rents, however. Increases to date have brought the rent level in Prague in 1998, relative to the cost of construction back only to roughly where it was when the rent setting system was instituted in 1962. Most cities have apparently not even followed Prague in moving rents up by the full amount permitted by the central government. Since the initial promise of deregulation at the central level in 2000 will not apparently translate into substantial movement towards market rents, the government is considering additional steps to reduce this major housing market distortion.

INSTITUTIONS: UNIVERSAL BANKS

As in other CE transition countries, the Czech Republic started with a dominant savings bank, CS, serving the household saving and loan market, and a dominant commercial bank, Komercni Banka (KB), drawing most of its funds from interbank loans from the CS. The stock of old, low-rate housing loans resides in CS, where it receives a flow of subsidies from the government. The large stock of bad socialist era commercial loans was moved out of KB to a government-owned work-out bank, but KB has already accumulated a new supply of bad loans that are threatening its capital base.

The bank privatization process has been fraught with delays and controversy, just as elsewhere in the CE countries. On the one hand, a large number of foreign-controlled banks have opened for business. On the other hand, there has been a reluctance to sell the dominant (state-owned) banks into foreign control, even to strategic investors. As elsewhere in the Czech economy, state ownership has been replaced by financially weak “private” ownership and diffuse governance by investment funds and management.

Most relevant for housing finance, the Czech retail banking market has been dominated by CS. Due to the absence of subsidies and strong loan recovery authority, CS did not seek to make long-term housing loans from 1993 to 1995, and the housing finance market languished. It appears that some of the motivation for creation of the building societies and mortgage bond instrument (see below) was to expand the number of suppliers of housing credit without having to rely on the other universal banks competing successfully for retail deposits. The same issue has arisen in the other three countries and is of some importance. In most cases, the housing finance market has benefited greatly from the presence of authentic competition.

One implication of this situation is that development of housing finance in the Czech Republic has become closely tied to development of alternative channels for funds. Although the Czech Republic has managed to avoid extreme differentiation in housing funding circuits, it has had to intervene with large subsidies, both to encourage demand and to get the sort of institutional development and competition that will push the evolution of the housing finance sector in the direction of a functioning lending market.

INSTITUTIONS: BUILDING SOCIETIES

Three of the four CE transition countries have adopted versions of the German and Austrian Bauspar system of separate contract-savings banks for housing. (Poland eventually rejected this model in favor of a locally-designed scheme.) Called home savings banks or building societies, these institutions are designed to collect savings deposits at a 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 forgo enough interest on average during the saving part of the

cycle (e.g., receiving 3 percent on their savings) to fund their interest savings during loan repayment (e.g., paying 6 percent 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 makes saving easier or because it provides the bank evidence that the savers are reliable borrowers), the public would participate in such a system set up by a regular bank. This has been tried in several countries,[41] but people do not seem to value the advantages enough to give up the flexibility of deciding when and how much to save and when to seek a loan.

A building society system moves beyond this simple model 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 better than other forms of savings, so that people will want to participate even if they are not sure they will want a loan after their savings period. If the return on savings is only just equal to the alternative market return (e.g., on bank deposits), people may still be attracted because the system conveys a significant subsidy to those who actually do borrow at the below-market rate.[42]

Several social benefits are claimed for building society systems. The simplest are the usual arguments for housing subsidies in general. The major added advantage claimed 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 he or she has a reliable character and, more importantly, is a good credit risk.[43]

An additional argument is sometimes made. If a savings system is set up where the subsidy is extra attractive compared to competing saving vehicles but only becomes available at the end of the savings cycle, a savings pool is created that is very stable in the short run. Few who start a contract will not find it worthwhile to finish their savings program. This encourages a steady inflow of funds and deters any sudden massive withdrawals. In theory, it is very desirable to fund long-term loans for housing out of such stable pools of resources. Although there are several more efficient ways of

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

[42] 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 building society would more easily run out of enough low-rate funds to offer such loans. In addition, building societies try to make loans for a longer term than the savings period, which requires some savers who do not borrow.

[43] 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.

constructing such pools in modern financial systems (e.g., pension savings), many policymakers still considered this stability to be a significant reason to subsidize the building societies.

Finally, proponents claim that tying a subsidized loan to completion of a savings program will encourage people to save more than they would otherwise and, thus, that building society systems will expand the supply of domestic household savings.

It should be noted that the rapid appearance of these institutions in the CE countries was not a coincidence. Very large potential commercial rewards are possible from such systems, especially in their early years when few participants qualify for a low-rate loan and the building society can invest the low-cost funds at market rates. Moreover, all four countries have had high market rates relative to the low rate due on savings and charged on loans. Policymakers in all the countries also report that strong lobbying efforts of German and Austrian Bauspar interests were decisive in causing creation of a building society system in their country (although there are important differences in the specifics across countries,[44] as highlighted in the Annex to Chapter 1).

The Czech building society system can be summarized as follows:[45]

Main Act:	25 February 1993, first operations in September 1993.
Regulation:	Ministry of Regional Development: regulation/ supervision of premium payment. Central Bank: regulation/supervision of the building societies, but following conventional bank regulations with no additional regulation imposed on liquidity management.
Yearly Premium Amount:	25 percent of savings, up to CZK 4500. Annual optimal savings CZK 18,000, 200 percent of the average monthly wage in 1993 (but only 130 percent of it in 1998)
Minimum Saving Period:	Five years to get housing contractual loan (usually at 6 percent) if 50 percent of the contracted sum is saved. Interim loans available at a higher rate after two years.

[44] A more in-depth comparison of the building society systems in Central Europe is available in the report by this author entitled "The Current Operation of the Bauspar Systems in the Czech Republic, Hungary, and Slovakia", September 1998.

[45] Based on research reported by Loic Chiquier.

	Saving for five years required to cash the premium, even if no loan taken.
Housing Purpose Required:	Not to withdraw savings and premium. But loan currently available only for housing purposes as demonstrated by invoices (although initial provisions allowed for non-housing purposes).

Other relevant aspects of the system:

(1) Interest and premium on savings are exempt from taxation.
(2) Premiums 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).
(3) Interest paid on loans now tax deductible, including interest on loans by mortgage banks.
(4) A market-rate housing loan can be taken immediately from the parent commercial bank, repayable by a bridge loan from the Bauspar after two years of savings.
(5) Parameters of the state premium embedded in law, with Parliament having to act to reduce or increase it.

The building society system has grown quickly in the Czech Republic. Four institutions became operational in the first year, and two more in 1994. The very first, the Czecho-Moravian Building Society, remains in the lead. All six institutions have strong minority participation by German Bausparkassen, with majority ownership residing in a Czech universal bank.

Table 2-3 gives the cumulative results of the system.

TABLE 2-3
ACTIVITIES OF BUILDING SOCIETIES IN THE CZECH REPUBLIC

	1993	1994	1995	1996	1997	1998	1999(est.)
New Contracts (000)	206	445	453	620	530	636	700
Contracts Outstanding (000)	206	651	1,104	1,560	1,967	2,400	2,700
Net Savings (Bil. CZK)	1.1	6.4	16.3	34.5	59.6	82	110
Net Loans (Bil. CZK)	0. 0	0.0	0.2	2.2	9.1	24.9	45
# of Loans (000)	0	0	0.9	17.9	65.5	191.1	350
State Premiums (Bil. CZK)	0.0	0.3	1.1	2.3	3.8	5.1	6.2
Premiums/State Budget (%)	0.0	0.1	0.3	0.5	0.8	0.9	1.0

As can be seen from Table 2-3, the building societies have been very successful in attracting savings and are starting to make huge numbers of loans. Their success has been due to extensive marketing and the attractiveness of the financial return on savings, independent of the value of the housing loan. Over the minimum five-year

savings period, the 25 percent premium on the annual contribution, on top of a 3-4 percent return on accrued savings, yields a tax-exempt return of about 12 percent. This return has been higher on an after-tax basis than most alternatives. Moreover, the building societies are giving savers a 1.5 percent bonus on top of the basic interest rate if savers decline their right to a 6 percent loan at completion of their five-year saving period. This provides an after-tax yield of over 13 percent to the "good brothers".[46]

In the Czech Republic, the building society system is attractive to most 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 percent at the standard tax rate of 25 percent on interest. Time deposits in banks paid only 10-12 percent before tax during this period, so that the after-tax yield was 7.5-9.0 percent. When these are contrasted with the 13 percent yield on savings in a building societies, it is easy to understand their success. The power of the subsidy has sharply risen as bank rates fell sharply in 1999. Total savings in the building society system have passed CZK 100 billion (over 12 percent of household deposits in the banking system).

The maximum of subsidy is achieved by saving at a rate of CZK 18,000 a year for five years. With interest and premium, this provides 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 build almost CZK 500,000 towards a housing investment. This relatively large amount, almost US$ 15,000 currently, is about 50 percent of the cost of a modest existing flat and 25-35 percent of the cost of a more substantial flat or a family house.

The average saving actually done per contract is only about half of this maximum amount (but growing over time). Many savers are expected to simply settle for the higher after-tax return on their savings and not take out a loan.

As of the end of 1998, building society customers had taken out almost 200,000 loans, totally drawfing the roughly 20,000 regular mortgage loans outstanding. More than 75 percent of these loans were “bridge” loans at market rate, to be paid off by a low-rate loan at completion of the contract. Two-thirds of these were for purchase of a housing unit. However, the total amount per loan is so little (CZK 130,000) that the volume of lending involved is not much more than that for regular loans. This suggests that a building society loan is being utilized in nearly every housing transaction (though it must be remembered that many households will use two such loans).

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

Market interest rates have trended down so sharply in 1999 (to 10 percent), however, that the rate on a regular loan for a new unit is actually less than 6 percent, once the 4 percent subsidy and tax deduction on interest is accounted for. If rates come down much further, the allure of the building society loan may fade. However, with deposit rates currently well under 10 percent, building society accounts as a savings vehicle are becoming irresistible. The government will need to reduce the 25 percent premium soon if they are to stop providing a savings subsidy far in excess of what is needed to support the housing finance system.

INSTITUTIONS: MORTGAGE BANKS

Officials speak of a "rebirth" of mortgage banks in the Czech Republic, since this mode of housing finance was common before central planning and even back in the 19th century. These earlier versions of mortgage banks were very similar to those in Germany, where distinct institutions with separate capitalization and specialized regulation offered investors a greater degree of security than did general commercial banks. When planning the “rebirth,” officials at the Czech National Bank were intent on following that model today, but officials at the Ministry of Finance were in favor of relying on general universal banks for most mortgage lending, rather than create a segmented institutional structure.[47] The result of this disagreement has been an arrangement that combines the best of both approaches.

Universal banks can obtain licenses for mortgage banking activity, as long as they keep separate legal and accounting records on the activity.[48] The "mortgages" that provide the collateral for the mortgage bonds are not physically segregated from the other assets of the bank. But they are legally segregated in case of default or bankruptcy, so that they serve exclusively as first-rank collateral for the bonds.[49]

This is a very important difference from the traditional German mortgage bank model. To this analyst, it captures most of the benefit of mortgage bonds—namely the presence of identifiable high quality collateral, without the full cost of operating a system of legally separate institutions. As a result, only one Czech mortgage bank was set up

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[47] In practice, this model of mortgage banking is more similar to that practiced today in Germany, where most universal banks have an affiliated mortgage bank that finances the eligible tranche of individual loans, but is part of the integrated product line of the mother bank. Moreover, the original motivation of distinct mortgage banking, to obtain a lower risk spread from investors, is no longer important, since bonds issued by major universal banks in Germany trade at nearly the same spread over government debt as do the *Pfandbriefe* issued by mortgage banks.

[48] In an interesting twist, free-standing mortgage banks can also take regular deposits whenever deposit rates are attractive relative to bond rates.

[49] It should be noted that, as in Slovakia, the Czech usage is to apply the term "mortgage" only to such secured housing loans that also qualify to back mortgage bonds. This is at variance with usage in most of the rest of the world and is not observed in this report.

as a separate entity and it is being folded into its mother bank. Some may argue that the protections for bond holders are not as strong. But in this day of well-developed risk pricing in bond markets and improved regulation and supervision of banks, the incremental value of forcing segregation and specialization of function is debatable. Moreover, it is not clear that mortgage banks are less risky than commercial banks, since they are free to engage in extensive financing of commercial properties.[50]

The current mode of evolution of mortgage in the Czech Republic banking allows seamless mortgage lending growth as mortgage banking evolves. The Czech Savings Bank has simply continued to make mortgages as before (as secured housing loans) and to fund them (as before) from the general deposits of the bank. Other entrants now have a way of raising funds aside from developing a base of retail deposits. In principle, since the cost of retail deposits has remained below that of bond-financing in general, this arrangement has allowed banks to pursue lending for housing as an integrated retail banking business, funding it in whatever way is cheapest. Thus, despite semantic maneuvering to declare this the rebirth of a mortgage banking tradition, it is closer to mortgage funding as practiced in the most advanced banking systems, complementing deposit-based funding with special access to wholesale funding through a secondary market issuance of mortgage-backed bonds.[51]

The Czech banks do pay a small price for this approach. They must conform their mortgages to a norm of mortgage banking, having interest rates that are fixed for a minimum of two years, in contrast to the flexibility U.S., U.K., and French banks have to offer both variable and fixed rate loans. To the extent that Czech banks are funding the loans out of short-term deposits, this has introduced an element of interest rate risk that would not be required otherwise. (It is not clear how important this issue is. Banks do offer a one-year fixed rate loan that could easily be funded out of shorter-term deposits, but this appears not to be popular.) On the other hand, the Czech mortgage banking law is not as restrictive as the German one, in that it permits the loan-to-value ratio to be as high as 70 percent.

The record of mortgage bond issuance provides interesting evidence for those countries considering adoption of the mortgage banking model. This author has argued elsewhere that unsubsidized bond-funding is unlikely to offer any strong advantage over deposit-based funding in transition economies. This has been the case in the Czech Republic, despite the significant advantage of tax exemption for mortgage bond interest.

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[50] It is notable that EU-wide rules adopted on mortgage banking permit it as part of a commercial bank, as long as it is properly structured and supervised.

[51] A weak point in the entire housing finance system seems to be the unresolved issues about auction and eviction. The loans backing the mortgage bonds are problematic as collateral as long as recovery is uncertain. In this respect, having the diversified asset base of the universal bank may be preferable for backing to a narrow base of residential mortgages. Perhaps not coincidentally, bonds issuance so far has been less than the amount of backing available just from commercial loans (where execution is less problematic); the banks are also seeking establishment of a government insurance scheme for their loans.

Of the CZK 18 billion in qualified mortgages disbursed through the end of 1998, only CZK 5.6 billion were funded out of the proceeds of mortgage bonds. And most of those issues were associated with a bank making loans primarily for commercial real estate (at higher rates). The one exception was the single mortgage bank that did not have unlimited access to funding from the mother bank. The cost of funding loans from medium-term retail deposits has been lower than the cost of funding through mortgage bonds, despite the fact that the interest on deposits is taxable and that interest on mortgage bonds has been 300-400 basis points below that on government bonds.

Seven mortgage banking licenses have been issued. As noted above, all but one of these were given to universal banks, not specialized mortgage banks, and the one specialized mortgage bank found it uneconomical to operate in that fashion. At the moment, only five mortgage banking operations are active. One of these is exclusively focused on making loans on commercial real estate and another is oriented towards commercial loans, loans for rental residential developments, and loans for high-cost houses. That leaves three mortgage banking operations competing for the bulk of the household market, all three of which are mortgage arms of the largest Czech universal banks.

As of July 1999, the cumulative volume of owner-occupied residential mortgages approved by these three banks was 21,708 loans for a total of CZK 30.3 billion, an average of about US$ 40,000 (but with many loans covering multiple unit family houses). The lending rate had tapered off from 1996 (463 loans per month) through 1997 (260 per month), presumably due to higher interest rates on loans starting in mid-1997 and greater competition from building societies, where many more contracts are maturing into loans. Lending rebounded strongly in 1998 despite the high interest rates, however, probably due to passage of tax deductibility of mortgage interest. Lending for commercial purposes has been running nearly as high as for residential purposes.

MORTGAGE DESIGN

Currently, the standard design for mortgages is a 20-year term, with a rate fixed for 5 years and prepayment subject to high, but negotiable, fees. For most households it is advantageous to take the full 20-year term and most do. The advantage is particularly great if the borrower qualifies for the 4 percentage point subsidy from the government, since this is payable out to 20 years. Even if not eligible for the direct subsidy, the interest on the loan is currently tax deductible, which reduces the effective real rate of interest to about zero percent, at least for high-income borrowers (in the 30-40 percent tax brackets).

As of June 1998, these loans were being offered at rates of about 14 percent for the first five years. One variant of this design is an option of a one-year adjustable rate

mortgage, convertible to a five-year rate at renewal. Since it was quoted at about 15 percent (the yield-curve being downward-sloping), it was not much used. However, rates came down to 10 percent in March 1999, an experience that may convince borrowers to consider adjustable rate loans in the future.

A recent innovation is a loan that does not require payments of principal for the first five years and then amortizes over an additional 20 years. This reduces the current monthly payment by about 12 percent, followed by a boost of 15 percent after five years. The later adjustment could be a problem, since annual inflation has dropped off sharply, to less than 5 percent.

Underwriting on these loans is based on calculations designed to ensure that remaining discretionary income exceeds 1.6 times the minimum living income for that family size (this parallels the approach in Germany). The net effect, apparently, is for a payment-to-net income (PTI) ratio of about 30-35 percent. In making these calculations, the 4 percent subsidy is deducted from the rate (if applicable) and the share of the tax savings due from deducting the interest paid is also removed from the net mortgage payment. (Legislation is being considered to permit borrowers to reduce their tax withholdings by the amount of these expected savings.)

Mortgage banking regulations allow loans with loan-to-value (LTV) ratios of up to 70 percent to be used as collateral for mortgage bonds, in contrast to the traditional German limit of 60 percent. Loans for up to another 20 percent of the appraised value can be obtained at a higher, floating rate. However, few take out such supplemental loans and the average LTV ratio is reported to be about 50 percent.

SUBSIDIES

The housing finance market in the Czech Republic is shaped by an explosion of subsidies since 1993. These include (1) grants to municipalities equal to about one-third of the cost of a panel flat, (2) the large premium provided for savings in building societies, (3) the 4 percent subsidy to mortgages taken out on new housing, (4) tax-deductibility of interest on mortgages, (5) tax-exemption of interest on mortgage bonds, (6) reduced value-added tax paid on housing construction, and (7) a near-grant of CZK 200,000 for construction of a new house.[52] Table 2-4 summarizes the costs of these subsidies. Notably, they are still less in total than the estimated amounts for Poland and Slovakia.

[52] This list omits two other major subsidies that might appear on list created by others. These are the very low rents on public and private rental units and the funds paid each year to cover the cost of pre-1989 below-market loans for co-ops and family houses. The latter is not really subject to central government choice at this time and the former is not directly affecting the financing of housing transactions on the market today.

Some aspects of these subsidies have been discussed above. This section examines them more systematically and assesses how they affect the markets for housing and housing finance.

New Municipal Rental Housing

The simplest subsidy is the grants to local governments to build additional multi-family rental housing. These grants consist of CZK 320,000 each unit towards construction and another CZK 50,000 towards infrastructure. In addition, the units built under this program benefit from free land from local governments. In 1998, about 7,800 units were supported in this fashion, for a total direct subsidy of CZK 2.9 billion. This was boosted in 1999 to 9,000 units at a cost of CZK 3.5 billion. Such levels suggest that about one-third of new housing stock is being produced in this manner.

The net effect of the program is to re-create the former system of subsidized co-operative construction. Prior to 1990, the state was providing about one-third of the financing in the form of grants. Another third was provided in the form of very long-term loans at 1 percent, which were effectively grants. One-third was provided by the would-be residents. Today, the central government pays one-third, the local government picks up one-third, and the “tenant” pays the last one-third in the form of the “prepayment of

The tenants in these new units expect to pay only the operating costs of the units for the first 10-20 years, depending on how many years of "advanced rental payments" are collected to finance the rest of the cost of construction. Beyond that point, the informal understanding is that the units will be sold to the tenants, perhaps at a nominal price and, of course, with the burden of having to undertake significant renovations in the near future.

This is a financially attractive proposition for all involved. The central government gets additional units built for a contribution of only CZK 370,000—compared with total subsidies of CZK 500,000-1,000,000 that could accrue to a new unit built by an individual and financed with (1) a large mortgage from a mortgage bank, (2) a CZK 200,000 10-year deferred "loan", and (3) a building society loan. The local government gets a new rental unit at a higher effective rent than the small amount it is getting currently and has to put up a relatively small amount of cash (apparently some are financing this through bank loans secured by municipal property) if it provides free land and infrastructure. The "tenant" is getting ultimate ownership for essentially one-third the full market cost of constructing such a unit.

The net effect on the market is to reduce the pressure on the existing stock and to reduce the potential number of borrowers from the housing finance system. The major negatives, aside from the drain on public resources, are the same as in the co-

operatives: The tenure situation in these new units is somewhat unclear, as is the responsibility of the tenants or local government for long-term renovation.

Building Societies

The 2.4 million savings accounts at the building societies will benefit from CZK 6.2 billion in state premiums in 1998. Building societies have been very popular because they provide savers an effective rate of return over the 5-year contract of 12-13 percent, which is not taxable, in contrast to the 10-12 percent, subject to tax, obtainable in an ordinary time deposit (until 1999, when rates fell sharply). This provides a significant incentive for almost all adult savers to open an account.

The ultimate purpose of the savings subsidies is to subsidize housing loans down to a stable rate of 6 percent. At the end of 1998, the building societies had about 191,000 loans outstanding for a total of about CZK 25 billion, with an average loan of CZK 130,000 (about US$ 3,800). About 110,000 new loans were made in 1998. This number is expected to increase rapidly as many more of the savers reach the five-year mark, when they can obtain a low-rate loan, or the two-year mark, when they are eligible for a bridge loan. Only 206,000 contracts were opened through December 1993. But an average of 500,000 a year have been opened since then, with the exception of 1998. The upsurge in building society loans expected over the next several years will probably significantly limit the demand for conventional mortgage loans made by commercial banks, certainly for renovation purposes and probably also for the purchase of existing housing. The larger loan size and extra subsidies for loans for new housing will presumably preserve this market for regular banks.

The special government loan program for new housing became available after 1 July 1997 and most participants have used it with a building society loan. It is claimed that the two subsidies together can make a large difference in the affordability of a new house. However, it is worth noting that the amount that can be borrowed from a building society at 6 percent is much less than from a regular bank at 10 percent, because the term on the building society loan (6-8 years) is so much shorter than on a conventional loan (20 years).

Mortgage Subsidies

Although the building society system receives a large subsidy for housing finance (part of which it passes on), conventional housing lending in the Czech Republic also benefits from a number of important subsidies. In fact, for people building new housing, the market rate of 10 percent is subsidized down to as low as 4 percent, below the rate on a building society loan. All these subsidies should over time promote mortgage borrowing in the Czech Republic to a greater degree than in the other CE countries.

Interest Reduction. In addition to subsidies obtainable through a loan after completion of a building society contract, would-be home buyers may be eligible for the special subsidy of 4 percent of the interest rate on a regular loan made by a "mortgage bank" (really a regular bank). This subsidy was introduced in 1996 to encourage new construction further.[53] The main requirements for eligibility are that the housing unit be new (self- or developer-built) and that the loan be a "mortgage", i.e., made by a bank that has a license to do mortgage banking and have a LTV ratio of no more than 70 percent. The size of the subsidized portion of the loan is limited to CZK 800,000 for a flat and CZK 1.5 million for a family house. (The subsidy has been available for loans on private rental units as well when the budget authority is not fully used by owner-occupiers.) Although the subsidy applies to the life of the loan (up to 20 years), in principle the size of the annual subsidy is subject to change at any time by the government, even for existing loans.

Since this special subsidy reduced the borrowing rate for new housing in 1998 to only 10 percent, from a market rate of 14 percent, it is surprising that only about 2,800 new housing units benefited from it in 1998—only about 15 percent of the new private units completed and less than 10 percent of the number started in that year. The volume of such lending has been so low, in fact, that this is the smallest of all the major on-budget housing subsidies, costing only 0.04 percent of the total budget.

Tax Deduction. An even more potent subsidy to mortgages was introduced in January 1998: the deduction from taxable income of the interest paid on housing loans. Since tax brackets range from 15 to 40 percent, many higher income households taking out a mortgage loan to buy a new house can see the effective rate on a loan at 10 percent reduced—by the 4 percent subsidy plus the tax deduction—to about 4 percent. This is below the rate of return on available investments, and even inflation, and should make borrowing very attractive.

This subsidy operates quite differently from the 4 percent subsidy. First, since it is applicable to all sizes of loan, it provides a subsidy to high-income households to build more lavish houses. It also assists moderate income households who take out a

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[53] The law provides for a 4 percent in the first year of the program and only 3 percent thereafter, but the government has never taken the step of reducing the subsidy.

loan to buy or renovate a modest existing flat. However, given that higher income households are not only more likely to borrow in order to invest available cash in other ways but are also going to borrow much more, the great bulk of this subsidy will go to households with above average incomes, just as the 4 percent subsidy does.[54]

In a notable turn of events, it was not long after this benefit appeared that the building societies, feeling threatened by after-tax rates on regular mortgages as low as their 6 percent rate, successfully lobbied to get this subsidy extended to their loans as well, leaving an after-tax rate on building society loans of 3.6 percent, as low as any effective loan rate in the U.S. or Western Europe.

Subsidies to Mortgage Bonds. Mortgage borrowers not only benefit directly from the 4 percent subsidy to "mortgages" and the tax deduction. They also benefit because mortgage bond interest is tax-exempt. This provision is potentially of considerable value to the bank and the borrower, since the tax rate on interest is 25 percent for individuals and 35 percent for legal entities. This value is reflected in the rates applicable to the mortgage bonds issued since interest on government bonds became taxable—rates that average a full 25 percent lower than rates on similar government bonds (10.6 percent relative to 14.1 percent).

Despite this advantage, the volume of bond issuance was only 30 percent of the volume of residential and commercial mortgage issuance through 1998—a situation that has at least two interesting aspects. First, it seems that mortgage banking, as opposed to universal banking, would have no place in the current housing finance sector in the Czech Republic if it did not have this subsidy. This may eventually change, because many of the deposits now funding mortgages are short-term and they may not be acceptable to regulators as backing for long-term mortgages in the long run. Second, it seems odd that individual savers are accepting rates on their deposited funds that are so much less than those on government debt. This may also change if investment funds or the Ministry of Finance provide access to government-debt returns for small investors. The principal beneficiaries of the subsidy are investors in commercial real estate, with the bulk of the bond issuances so far going to refinance commercial and rental real estate.

The cost to the government has been relatively small. With CZK 5.6 billion in bonds outstanding at the end of 1998, mostly held by banks and pension funds, the annual interest that would have been paid if the bonds were taxable would be about CZK 700 million, with forgone taxes about CZK 200 million. If, in the medium term,

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[54] This is confirmed by the available evidence. The average mortgage loan taken out by an individual is running about CZK 1.3 million. Based on an average LTV of 50 percent, the average house value has been about CZK 2.6 million. If the payment-to-income ratio averages 33 percent or less, the average income would be at least CZK 500-600,000 a year (about US$ 15,000 a year) more than double the average household income.

such bonds start to provide a larger share of the financing for housing loans (as they should eventually, given their significant advantage), the outstanding amount could grow into the range of CZK 50 billion and the loss in revenue CZK 1.0-2.0 billion. This is relatively small compared to the cost of the building society system, but still significant.

Tax-Exemption of Mortgage Banks. In an extra effort to facilitate mortgage financing, the lending activities of mortgage banks themselves were declared tax-exempt in 1994. It is not clear whether this applies to lending for commercial real estate or just residential loans. In any case, this subsidy is being passed through to borrowers via the small spread charged in this area. There is a significant cost in lost tax revenues, over CZK 250 million if the net margin on these loans is 1.0 percent.

Zero-Interest Loan. In July 1997, the government added yet another source of subsidy, targeted specifically towards relatively moderate income households (but restricted to new construction). The program is portrayed as a loan of CZK 200,000. But in order to bolster the ability of a household to complement a regular loan with cash and to avoid burdening that household with higher repayments in the beginning, no payments are due for the first 10 years. The loan is then repayable over another 10 years with no interest. The present value of such repayments, even at a low-discount rate of 10 percent, is less than CZK 50,000. So it is much closer to a grant than to a loan, and is treated as such by both borrower and bank.

An odd aspect of the grant/loan is that it must be taken out in conjunction with a mortgage or building society loan. Presumably, this is to make sure there is an institution to service the loan after the first 10 years. (The intent might also be to restrict the program to those who have already shown the need for additional funds by taking out a loan, but this seems unlikely to be effective.) Apparently, almost all such borrowers have chosen to combine their zero-interest loan with the building society loan alternative.

There are income restrictions on this subsidy, with a ceiling of four times the so-called "minimum living income," which varies according to household composition. As of early 1998, this wage for a family of four would be US$ 4,100, thus setting a limit on the eligible income of about US$ 16,400. Since this is about 2.5 times the average income of a non-pensioner Czech household, the program does not appear to be significantly targeted in reality. However, it is a very sensible program in general, because it works through a direct grant that can be targeted, and does not involve the waste for administration and profit that is involved in subsidizing loans through the building societies and mortgage banks.

A large amount was budgeted for this program in 1999, CZK 1,450 million, enough for 7,250 housing units. But, because of the non-binding nature of the targeting, all of the budgeted amount was committed by April. The program is being

reviewed and may be ended. However, it is arguable that it is more desirable to replace the deduction for interest income and the subsidies to mortgage bonds with such a more targeted and limited grant.

Reduced VAT Rate

The general VAT rate is 22 percent, but housing and other forms of construction bear only a 5 percent rate. The 17 percent differential probably constitutes another 10-12 percent subsidy to the cost of new housing, on top of all the other subsidies available to new housing, both public and private, rental and owner-occupied. (Without more information about enforcement of the VAT and the presence of special rates for other sectors it is impossible to be more specific about the size of the subsidy.) There can be little doubt that Czech society is serious about shifting much of the cost of housing away from the individual household to society as a whole.

TABLE 2-4
MAJOR SUBSIDY PROGRAMS, 1999 (affecting the current market for housing finance)

Program	Budgeted Amount (CZK Millions)	Number of Units	Amount per Unit (CZK)	Targeting
Municipal Rentals	3,480	9,400	370,000	New, modest size, low-rent
Building Societies	6,250	2.4 mil. contracts	2,600/contract	All Housing
Mortgage 4% Subsidy	250	8,850 cumulatively	28,000	New Housing
Interest-Free Loan	1,450	7,250	200,000	New Housing, Middle-income
Tax Deduction	???			All Mortgages
Tax Exemption of Mortgage Banking	250	20,000	12,500	All Mortgages
VAT Reduction	???			New Housing
Total	> 11,680 (> 2.0 % of Budget)			

Combining Subsidies

As noted above, the most striking aspect of the housing finance market currently is how few households actually use formal sector finance, despite the high degree of subsidization available. To some extent, this pattern, which is echoed in other CE countries, seems to reflect an aversion to long-term debt at anything other than almost grant-type terms. In this sense, it may be unfair to calculate the subsidy granted to someone as the full difference between what is actually paid and what the market says is the cost of funds (since few would be willing to pay the full market cost). But in an economic sense it is the correct calculation. The market cost of the funds is the true

opportunity cost to society of providing the funds—and the only relevant economic yardstick.

The potential subsidies from this full market cost are quite significant in the Czech Republic. Typical might be a household earning about CZK 400,000 a year and buying a new family house costing about CZK 2.0 million. Such a household, usually with two workers, could open two building society accounts and save steadily at up to CZK 36,000 a year. This savings effort would be about 10 percent of their annual income, which is not unusual in such circumstances, and can be supplemented with assistance from previous savings and relatives. If they started their savings contracts in 1993, they would have building society savings of CZK 240,000 in 1999, enabling them to borrow another CZK 240,000 at 6 percent, repayable over eight years at about CZK 3154 a month.

They can then go to a bank and get a mortgage at a stated interest rate of 10 percent. If they are buying a new house, the actual rate will be 6 percent, which will also be deductible from their taxable income. If their tax bracket is 32 percent, the effective rate on the loan will be only 4.1 percent, and the bank will lend them an amount such that the repayment, net of tax savings but including their building society repayment, will be 33 percent of their income—in their case, a loan of about CZK 1,200,000. In addition, they are eligible for one of the CZK 200,000 interest-free government loans made available in 1999.

All these sources of finance together will cover CZK 1.9 million of the CZK 2.0 million cost of the home they want to buy. In other words, a small additional cash contribution is still required over and above the CZK 240,000 available from the building society accounts. This is not surprising, since the cost of the house is five times the annual income of the household. While the need for this additional cash could be avoided by buying a more modest new house or an existing house, it is more likely that other funds can be made available, from savings, parents, or equity from flats bequeathed by living or deceased grandparents.

The net effect is to shield this household from the true cost of the house that they are buying. Presumably such a situation is a goal of the government subsidy policy. If the present value is calculated of all the subsidies incorporated into this transaction, it comes to about CZK 600,000, reducing the price from CZK 2.0 million by 30 percent, to about CZK 1.4 million. Notably, this 30 percent subsidy is substantially less (in share, not amount) than that available to tenants in the new municipal rental units, who have to put up only about one-third of the amount to obtain effective ownership rights to their unit (equivalent to a 66 percent subsidy). It is also much smaller than the subsidy available to tenants in old-style municipal flats, who pay less than one-third the full market rent for their flat.

TABLE 2-5

SUBSIDIES AVAILABLE TO TYPICAL BUYER OF A NEW HOME

Household Income:	CZK 33,333/month	
Price of Flat:	CZK 2.0 million	
Financing:		
Building Society Savings (2 accounts):	CZK 240,000	Subsidy Element: CZK 10,000
Building Society Loan:	CZK 240,000	Subsidy Element: CZK 60,000
Mortgage Loan:	CZK 1,200,000	Subsidy Element: CZK 380,000
Interest-Free Loan:	CZK 200,000	Subsidy Element: CZK 150,000
Other Cash:	CZK 120,000	
Totals:	CZK 2.0 million	Subsidy: CZK 600,000

OTHER FACTORS AFFECTING THE HOUSING FINANCE MARKET

The past and recent history of housing policy, the institutional structure of the housing finance sector, and the subsidies that help shape the market for mortgage finance have now been reviewed. There remain a number of other important factors which affect either the demand for finance or supply of funds (i.e., the willingness of lenders to make loans).

Demand Factors

The single most important factor affecting the demand for mortgage finance is how expensive it is to borrow long-term funds. Much of that cost is determined by inflation and the general real interest rate on funds, which together determine the general cost of funds (say to the government). The actual cost to would-be borrowers is this rate plus a margin for the lender to cover costs, risks, and profits.

Inflation in the Czech Republic fell off rapidly after hitting 57 percent in 1991, to 11 percent in 1992, and 21 percent in 1993. It then stayed around 10 percent from 1994 to 1998, but declined sharply in 1999 to below 5 percent.

Until 1996, the real spread between inflation and government debt rates was relatively small, about 1-2 percent. This spread expanded when government debt became taxable, however, and has been in the range of 4-5 percent for the last twelve months. Despite rates of 10 percent on government debt and even higher rates on inter-bank lending, the rate for residential mortgages has been quite low, also about 10 percent, which is clearly "below-market." An interesting question is whether the banks

are doing this for political reasons and whether they are also rationing their lending through stringent underwriting. Part of the explanation presumably is that the mortgage banking activities of banks are tax-exempt. The truly private (no state involvement) mortgage banks are focusing on commercial real estate lending at 13-14 percent.

These levels of nominal interest rates have not raised the issue of the "tilt-effect" of inflation, which makes loans unaffordable even if bearing a reasonable real interest rate. And there has been no activity in indexed or foreign currency loans.

For consumers, it is hard to imagine a more attractive situation for "market-rate" housing finance in a transition country. The Czech experience with unemployment has also been more benign than in the other countries and real income growth has been high, both of which should serve to encourage the use of long-term finance for housing. Loans for new construction benefit from a rate reduction that reduces the real rate to close to zero. Tax deductibility of mortgage interest is now making them negative for new construction and 0-2 percent for buyers of existing houses.

As indicated in Table 2-6, conventional lending by banks started relatively slowly, had been declining in absolute terms despite the boom in private housing starts, but then rebounded, apparently in response to the deductibility of interest as of January 1998. Even at current levels, however, it is below the rate of borrowing in Hungary and Poland, where the real cost of funds is substantially higher.

TABLE 2-6
NUMBER OF RESIDENTIAL MORTGAGE LOANS APPROVED

Year	Total # of Loans	Value of Loans (CZK million)	# of Subsidized Loans	# of Subsidized Units[a]	Value of Sub. Loans (CZK mil.)
1996	5,552	5,521	2,023	2,394	2,127
1997	3,455	5,117	1,690	2,214	1,867
1998	5,101	7,759	1,766	2,768	1,934
Up to 7-1999	2,934	3,902	1,212	1,336	1,414

Note:
a The number of units financed is more than the number of loans because some family houses are built with 2 flats and because some residential loans are to build market-rate or municipal rental buildings.

An important sub-group of these loans are eligible for the 4 percent subsidy on the interest rate. This eligibility simply requires that the units be in new construction. Even units in market-rate rental buildings are eligible as long as they are new. (The amount eligible for the subsidy is limited to CZK 800,000 for new flats and CZK 1,500,000 for family houses.)

These latter figures can be compared with the production of new housing in Table 2-1 (above). The total includes flats being built for sale, flats being built for market rent, flats being built by municipalities, and private family houses. The data only permit separate statistics for the number of housing starts of units in family houses. These starts averaged 13,830 per year in 1996 and 1997, or 1,152 a month. In comparison, subsidized loans were made at the rate of 192 units a month—about one out of six relative to family housing starts. Of course, there were many private flats, including some rental flats, that also qualified for such a loan. The exact number is not known but total eligible units amounted to at least 16,000 per year, implying an overall use rate of mortgage finance, even when subsidized to a zero real interest rate, of less than 15 percent.

In contrast to mortgage financing, the prospect of zero-rate and building society loans has aroused great interest. This experience suggests that people in the Czech Republic, as elsewhere in the CE, are not very interested in using debt for housing unless it contains a significant grant component.

Supply Factors

Housing finance is a very political issue in the Czech Republic. This may explain why the main market-rate lenders, which were until recently all directly or indirectly state-controlled, do not seem to be charging a proper premium over risk-free investment opportunities. One result may be an implicit credit rationing process, which may be limiting the supply of housing credit, despite the appearance of extensive competition. There is no evidence on this issue, however.

Lenders in the Czech Republic appear less concerned about loan recovery than those in the other countries. In 1994, the requirement of "equivalent substitute housing" for those being evicted was reduced to only "shelter". A proposal to strengthen the auction process has been under consideration for two years, and is seen as needed to provide a greater comfort factor.

Although lenders state a belief that Czechs have a low propensity to default and that loan recovery mechanisms are acceptable, they have also been supporting a proposal to shift the risks to a government insurance entity. This may reflect an unspoken concern that, even if the legal structure will back up the banks' rights to recover, the political system may not.

This issue of ensuring low potential defaults is a bit more pressing in the Czech Republic than in other CE countries, because a significant portion of mortgage funding may soon be coming through issuance of mortgage bonds. The Czech Republic has adopted the structure of German housing finance, but such a structure is built on the assumption that mortgages are rock-solid collateral to mortgage bonds. In the Czech Republic, this may be in doubt.

CHAPTER 3

HUNGARY

Population: 10.1 million (1998)
GDP: HUF 10.0 trillion (1998)
State Budget: HUF 3.0 trillion (1998)
Exchange rate: HUF 215/USD 1.0 (1998)

BACKGROUND

Housing Finance Under Socialism

In the early years of Communism, Hungary, in common with the other countries of Central Europe, emphasized state-owned rental flats to house the burgeoning industrial work force. But when the other countries were moving towards co-operative housing tenures in the 1970s, Hungary shifted towards supporting full-scale private ownership, of both family houses and condominium flats. This support took the form of below-market finance, lump-sum subsidies, and subsidized access to land and infrastructure. From the point of view of Hungarian policymakers, reliance on private housing tenures reduced the burden on the state for initial finance and on-going maintenance at the same time that it boosted public morale.

This tilt, combined with the absence of large cities other than Budapest, made Hungary's private ownership rate the highest in the CE countries by the end of the 1980s. As of 1990, its overall housing stock of 3.9 million units was distributed in the following manner:[55]

Housing Unit Status in 1990:

Owner-occupied (incl. condos)	77 %
Public Rental (incl. employer)	22 %
Private Rental	1 %

At that time, construction of state-owned or employer-owned units still occurred, but had been cut back sharply. Condominiums and family houses were the primary form of new housing—with about 40-50 percent of their cost financed out of grants through local governments, zero-rate loans from employers, and subsidized finance from the state savings bank, usually at 3 percent for 30 years. The rest was financed by the would-be residents out of cash savings or windfalls, as well as sweat equity in the case of family houses and subsidized land and infrastructure in the case of condos (all

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[55] Data is from Hegedus, J.; Tosics, I.; and Mayo, S., "Transition of the Housing Sector in the East Central European Countries," *Review of Urban and Regional Development Studies*, 8, 1996.

of which were built by the state). The net present value of that subsidy has been calculated as 20-30 percent of the total cost, distinctly less than the combination of grant and subsidized loan involved in most co-operatives.

As elsewhere, the below-market financing available from the state savings bank was financed through a combination of low interest rates on deposits and cross-subsidization of loans to enterprises.

Initial Adjustments

From 1990 to 1994, several important adjustments were made in the housing and housing finance sectors. Legislation was enacted to provide for the transfer of most state-owned stock to municipal governments and privatization of that stock to sitting tenants. Local governments were required to offer privatization at very low prices, so that even by 1994 about 40 percent of the former state rentals had been privatized (a share that has since grown to 70 percent).[56] Thus, by 1994, the end of state-sponsored construction and privatization had shifted tenure patterns even further towards private ownership:

Housing Unit Status in 1994:

Owner-occupied (incl. condos)	86 %
Public Rental (incl. employer)	13 %
Private Rental	1 %

The private rental share did not appreciably increase because Hungary pursued restitution through voucher claims on general state property rather than through specific properties.

The biggest problem facing the government in the short-run was the stock of outstanding low-rate loans used to finance private ownership. This finance subsidy grew suddenly as inflation rose and interest rates were allowed to go to "market". Since the old funding was through the state bank (i.e., from depositors), not from state funds, there was a massive increase in effective subsidy for both old and new borrowers.

Two adjustments were made in response to this shift. First, new loans were explicitly made at the floating rate set by the state savings bank Orszagos Takarekpenztar (OTP), and the subsidy level was created by providing a percentage reduction in the repayment. This approach had the advantage of stabilizing the subsidy element to some extent and introducing the borrowing public to the application of

[56] Hegedus, J., and Zsamboki, K., "The Transformation of the Housing Finance Sector, 1989-1998," prepared for the Conference on Housing Finance in Hungary, 11-12 November, 1998.

variable market rates. It had the disadvantages of rapidly building up a further large state liability and of encouraging more finance use than was really needed.

The second adjustment was an attempt to reduce the burden on state budgets of the "old (pre-1989) loans." The initial approach, to raise the fixed interest rate from 3 percent to 15 percent, was rejected by the Constitutional Court. But a different formulation was accepted in 1992. This offered pre-1989 borrowers a choice between (1) a write-off of half the outstanding loan and a market rate on the other half or (2) a 12 percent rate on the entire loan. In both cases, the government undertook to fully compensate OTP. The written-off principal was replaced by long-term state bonds and the difference between 12 percent and the current OTP rate was paid out of the state budget. The payments for both of these compensations were initially on the order of 2 percent of the state budget, but have declined to less than 1 percent recently, as inflation has boosted the budget. This burden has been larger than in the Czech Republic or Slovakia (but about the same as in Poland), both because inflation has been higher and because subsidized finance had been more widely used before 1989.

As in the other CE countries, during the 1989-1994 period Hungary used the housing sector to absorb some of the macroeconomic shocks. With its tradition of construction for private ownership and the common use of loans to individuals (not co-operatives), Hungary's support naturally took the form of deep subsidies to construction of owner-occupied housing, rather than support for continued production of co-operatives or municipal rentals.

Since Hungary does not compile data on housing unit starts, the impacts of changes in economic and financial conditions do not usually show up until completions data are available one or two years later. In fact, economic conditions had been very weak in Hungary in the latter half of the 1980s and state-sponsored housing production had been on a sharp downward trend since 1980. The decline in completions in 1990 seen in Table 3-1 reflected the cutback in state-sponsored construction that was already underway. The further declines in 1991-3 resulted primarily from private retrenchment starting in 1989. The upturn in 1995 reflected the start of the economic recovery, as well as a huge new subsidy scheme in 1994.

TABLE 3-1
COMPLETIONS OF HOUSING UNITS IN HUNGARY: 1989-1998

YEAR	# Of Units Completed (000)
1989	51.5
1990	43.8
1991	33.2
1992	25.8
1993	20.9

YEAR	# Of Units Completed (000)
1994	20.9
1995	24.7
1996	28.3
1997	28.1
1998	20.3[a]

Note:
a This figure is distorted by delays in completions due to hopes of becoming eligible for increased subsidies from the new government. Completions are expected to rebound in 1999 to 30,000.

The low point of the completion cycle was in 1993-4, with only 21,000 units completed a year, of which almost 90 percent were privately built. This low point was reached earlier than in the other countries, where subsidies were poured into state-controlled construction schemes, mostly through co-operatives. In Hungary, although large subsidies continued to be offered after 1989, they had to work entirely through the private sector, where interest in building additional housing was more strongly affected by macroeconomic conditions.

Macroeconomic Evolution

The Hungarian economy was one of the slowest in Central Europe to begin its recovery. Part of the reason was negative population growth over the period, but a more important part was a different approach to economic restructuring. To move the bulk of the economy to private ownership and at the same time attract foreign direct investment, most important state holdings, including major utilities and other infrastructure, were sold off. The result was a sharp rise in unemployment but also record foreign direct investment (per capita). Although financial retrenchment slowed the economy again in 1995, the general view today is that the basis has been laid for an extended period of strong economic growth.

EVOLUTION OF HOUSING POLICY

Hungary is well-known for having started the transition with a more private-sector oriented economy than other CE countries. As noted above, this has applied to the production of housing ever since the early 1980s. Thus, the adjustments in housing policy necessitated by the political changes in 1989 were in magnitude rather than in nature. The basic structure of supports for the sector—i.e., a system of grants and subsidized loans to private owners—was left in place but modified to accommodate the steep increase in inflation.

In fact, the actual subsidy policy in place from 1989 through 1993 had been decided as early as the end of 1988, nearly a year before the fall of Communism. The change had been necessitated by a flagging real economy, inflation of over 8 percent, and the need to shift to more flexible interest rates throughout the economy. As of 1 January 1989, the old system of fixed nominal interest rates on housing loans for private construction was replaced by a percentage subsidy of the loan repayment.

The percentage repayment subsidy and the maximum loan amount varied according to number of minor children in the household and whether the loan was for new or existing housing. A typical scheme was a 70 percent repayment subsidy for a family with two children buying a new house or flat, with a maximum loan equal to about US$ 7,000. The same size family would get an initial 30 percent repayment subsidy on the same size loan for an existing house. In both cases, the subsidy percentage was halved after year 5. For the new housing it was then further reduced to 15 percent for years 10-15 and zero for years 16-20.[57]

In addition to this subsidy linked to housing loans, Hungary offered those buying or building new housing a lump-sum grant also dependent on the number of children. As of 1989, this grant, 200,000 Hungarian Forints (HUF) was worth about US$ 4,000, although its effective value declined sharply as inflation boosted house prices. In 1989, the grant amount, plus the subsidized loan from the central government and employer and local government grants and loans, was about 40-50 percent of the cost of a new house.

The percentage repayment subsidies may have appeared to be reasonable in 1988, but as inflation rose above 20 percent and interest rates above 30 percent between 1989 and 1993, the immediate burden on the state budget grew rapidly. How to lessen this burden was a difficult problem; however, since complete removal of the subsidies would have effectively made mortgage finance unaffordable. The Ministry of Finance, together with technical assistance sponsored by USAID, developed a plan to withdraw most of the loan subsidies (except to a limited extent on new housing) and encourage, instead, the deferral and capitalization of part of the inflation-related premium in the market interest rate.

This plan was implemented in 1994, using a mortgage design called the deferred payment mortgage (DPM). The DPM differs from the DIM used in Poland in several ways. The DPM does not rely on indexes, neither the CPI for outstanding balance nor wage indexes for repayment, and the loan term is fixed. The DPM simply says that only a certain amount (based on a 10-15 percent interest rate) of interest will be charged currently and the difference between this amount and the amount due at the full market

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[57] It is noteworthy that Hungarian borrowers were sophisticated enough about mortgages and subsidies in 1989 to generally take a term of only 10 years, although 20 years was offered. This step would raise the initial payment but in so doing would attract a larger total subsidy.

rate will be deferred for later repayment. Periodically, the payment amount is reset to amortize the outstanding principal and deferrals over the remaining term. This design allows bank and borrower to set the amount to be deferred based on market conditions, rather than simply defer the whole of the inflation premium. It was also believed to be simpler to understand, since no indexes were involved.

From 1989-93, the flow of funds into financing private housing remained relatively high, supported by the repayment subsidies as well as the government grants and low-rate loans from employers and local governments. This supported a relatively high level of personal construction or purchase of new condominium flats. The new housing market was also supported by the relatively extensive privatization of the public rental stock. In contrast to the other CE countries, Hungary's extensive privatization created conditions supportive of (former) tenants selling their units on the regular market (in contrast to the inefficient gray market in public flats that already existed) and channel the resulting equity into a new unit.

Despite Hungary having (1) the best initial situation for housing in 1988, (2) a per capita rate of new housing production that exceeded that in most of the other CE countries, and (3) actual shrinkage in the population, policymakers in Hungary (as elsewhere in CE) felt the need to boost new production up from the low levels of 21,000 completions in 1993-94. At the same time as the Czech Republic and Slovakia were experimenting with indirect supports through building societies and mortgage banks, Hungary simply sharply increased its lump sum support for relatively large families acquiring new housing. At the end of 1994, this support for a family with two children was increased from the HUF 300,000 level (to which it had been increased in 1993) to HUF 1,200,000 (about US$ 10,000). For those with 3 children, the grant jumped to HUF 2.2 million (about US$ 19,000), over half the cost of many new houses.

Housing completions did rise significantly afterwards, by almost 35 percent from 1995 to 1998. However, this deep grant subsidy has been very expensive—with HUF 110 billion paid out for such grants (about 1.2 percent of the country's total budget) over the period. Notably, this rebound was much smaller than experienced by countries that chose to expand construction through official organs, such as local governments, rather than rely on individuals to respond to incentives.[58]

Only recently has Hungary implemented new housing finance structures. Building society legislation was passed in 1996, with operations beginning in June 1997. Mortgage banking legislation was enacted in 1997, with a government-sponsored

[58] This is not to suggest that using official organs is better housing policy. Just the opposite is the case; additions to the stock of "social" housing come with a heavy burden of unclear tenure, inefficient liquidity and mobility, and uncertain long-term maintenance. Also, the rebound in the former Czechoslovakia was from much lower levels.

mortgage bank beginning operations in 1999. (Both are discussed in detail later in this paper.)

During the 1990-1998 period, a number of other important legislative steps were taken to strengthen the housing market in the long-term. Private landlords, who were already exempted from rent limitations, received substantial legal support for limited lease terms and eviction in case of non-performance. And a number of laws and regulatory steps were taken to give lenders greater ability to foreclose and evict in cases of non-payment.

INSTITUTIONS: UNIVERSAL BANKS

As in other CE transition countries, Hungary started with a dominant state savings bank, the Orszagos Takarekpenztar (OTP), serving the household saving and loan market and funding the commercial banks. In addition, a number of large state-owned commercial banks were set up just prior to 1989. As elsewhere, the bank privatization process has been fraught with delays and controversy. In particular, a large accumulation of bad commercial loans had to be moved out of the commercial banks (which took three waves). And, most banks are being privatized to strategic investors. (In fact, Hungary stands out for having invited greater foreign participation in its privatization efforts generally.)

The one major exception to foreign participation has been OTP itself. OTP successfully resisted privatization to outsiders, proceeding instead with a sale of shares to its own management and to the general public. As a result, the revitalization (or at least replacement) of management and true separation from political forces, typical when control passes to a few major outside private investors, have been missing. Despite this, OTP's grip on the retail deposit market has remained strong and has deterred entry of other banks into the housing finance market.

The role of the former state savings bank in Hungarian housing finance has been different than in the other countries, simply because financing individual private housing had been a major activity for OTP for a long time. As long as the subsidies to mortgage loans remained high in the early 1990s, loan volume remained high. Despite this, the total OTP portfolio of private loans, by far the largest in the CE countries, has been declining in real terms since 1989. This decline accelerated when new lending fell after subsidies were cut back in 1994, and has accelerated even more as the real rate on OTP loans has been at very high levels and many of the loans made from 1989-1993, with the repayment subsidies, have passed into the lower subsidy period after the first five years.

Even at these reduced levels, OTP's activity levels in private housing finance remain higher than the lending in most of the other countries. In 1998, OTP made

about 18,000 loans of all kinds for housing (not including loans it administered for employers and local governments). The majority of these were conventional loans, without any form of deep subsidy. In contrast, the three major mortgage banks in the Czech Republic made only 5,101 loans in 1998, despite a much larger subsidy. OTP has also become a major player in the building society business, just as Slovenska Sporitelna has in Slovakia.

As of 1998, two other commercial banks have been competing with OTP in making housing loans. Initially, neither competitor moved aggressively to take market share. However, in 1998, K&H Bank made about 550 loans, for HUF 1.0 million each on average. In addition, Postabank started to offer housing loans, completing about 270 transactions. All these loans were for existing houses, partly because of the costs of dealing with the subsidy schemes for new housing.

While these amounts would not have registered at all in 1993, in the much shrunken market of 1998, they amounted to about 15 percent of the number of loans and 21 percent of the loan volume for the purchase of existing houses. This does not count loans tied to youth contract savings, a now defunct program confined to OTP. This is a significant amount of non-OTP lending and a recent escalation in OTP marketing efforts suggests that the fruits of competition may not be too far in the future. Even so, Hungary lags distinctly behind Poland and the Czech Republic in this regard.

INSTITUTIONS: BUILDING SOCIETIES[59]

All four CE transition countries have adopted versions of the German and Austrian system of separate contract-savings banks for housing, Bausparkassen. These institutions are designed to collect savings deposits at a below-market rate and recycle the low rate on their funding into low rates on their loans. As explained in the chapter on the Czech Republic, in the simplest version of such a system there is no net gain to depositors, just certain supposed non-financial advantages that would make them want to participate. However, in practice, there is always a significant government subsidy to "sweeten the pot" to attract more savers to participate.

Prior to 1997, Hungary operated a contract savings program through OTP that promised a loan with a 50 percent repayment subsidy over a 10-year term. Although significant liabilities remain under that program, the new building societies have proven far more popular, both because the subsidy is greater and because the potential profitability to the bank is far greater, thus inducing the entry of several competitors and extensive marketing efforts.

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[59] The name of these institutions in Hungarian translates to English as "housing savings banks", which is closer to the German designation, but the institutions refer to themselves in English as "building societies."

The Hungarian building society system can be summarized as follows:

Main Act:	November 1996, first operations in May 1997
Regulation:	Ministry of Finance regulation/supervision of premium payment. Central Bank and the Monetary and Capital Market Supervisory Board regulation/supervision of building societies, following extensive special regulations and restrictions, modeled after ones in Germany but modified, especially on provisioning and liquidity management.
Yearly Premium:	In 1997, 40 percent of savings, up to HUF 36,000 and annual optimal savings of HUF 90,000. In 1998 and 1999, 30 percent of savings, with the same maximum and optimal savings of HUF 120,000, about 12 percent of the average annual net wage in 1999.
Minimum Saving Period:	Four years to get housing contractual loan (usually at 6 percent) if 50 percent of contracted sum saved. Interim loans available at a market rate after two years. “Instant” loans, to be repaid upon completion of a savings program, available from “mother” banks. Saving for eight years required to cash the premium without use for housing (also 0.5 percent interest premium). Housing purposes of loan to be demonstrated by invoices.
Housing Purpose Required?	Housing purpose required to withdraw savings and premium, except after eight years. Loans are only for housing purposes as demonstrated by invoices.

Other relevant aspects of the system include:

(1) Interest and premium on savings exempt from taxation (but so is interest on regular deposits).
(2) Premiums paid into the account two months after the end of the "contract year" (the 12-month cycle since start of the account).

(3) Interest paid on the loans not tax deductible (in contrast to a limited deduction for loan repayments on ordinary loans for new houses).
(4) Accounts that can be tied to issuance of a market-rate housing loan immediately (by the parent commercial bank), repayable by a bridge loan from the building society after two years.
(5) Parameters of the state premium embedded in law, with Parliament action needed to change it.

The building society system has grown quickly in Hungary. Three institutions were able to get into operations in the first year, and one more started 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 3-2 gives the cumulative results of the system.

TABLE 3-2
ACTIVITIES OF BUILDING SOCIETIES IN HUNGARY

	1997	1998	1999(est.)
New Contracts	300,000	100,000	200,000
Contracts Outstanding	290,000	350,000	500,000
Net Savings (Bil. HUF)	10	30	
Net Loans (Bil. HUF)	0	0	
State Premiums (Bil. HUF)	0	4.0	8.2
Premiums/State Budget (%)	0	0.1	0.3

As can be seen from Table 3-2, the building societies were very successful in drawing in savers in the first year. Their success was due partly to their extensive marketing efforts and partly to the feature of the law that provided for a drop in the premium after the first year (a compromise with the building society interests in the Parliament due to the expected decline in inflation). This implied that, if one were thinking of starting a building society account over the next 2-3 years, the optimal time would be in 1997.[60]

The maximum subsidy was achievable by saving at a rate of HUF 90,000 for the first year (starting in 1997), and HUF 120,000 for each of the next three years. With interest and premium, this would provide total savings of about HUF 630,000 after four years. If one spouse matches this with a loan of the same size and the other spouse also establishes a savings contract and takes out a loan, a couple can acquire a total of about HUF 2.5 million towards a housing investment. This is a not a small amount,

[60] As a result, new contracts fell 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. New contracts have rebounded in 1999.

about US$ 11,600 at the 1998 exchange. The effect on the exchange rate of three more years of inflation can be expected to reduce this to US$ 8,000. But that would still be 40-50 percent of the cost of a modest existing flat.

For those starting contracts before 1 January 98 and saving over the minimum four-year 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 after that will yield a return of only 16 percent. Both returns were only a bit higher than that on one-year bank deposits at the time, but the rate on bank deposits was expected to decline over the next four years (and it has done so). Thus, the building society account offered, and continues to offer, a significantly better return than the banks over the full period, balanced by a loss of liquidity. The size of the extra return in Hungary is not as large as in the other countries, however.

Moreover, Hungary has a provision that those who do not have a housing purpose for their savings must wait for eight 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," because the homeownership rate is 92 percent, most homeowners have some significant maintenance expenses, and repaying existing housing loans or funding the housing expenditures of close relatives qualifies for both the savings premium and a subsidized loan.[61]

Because the building society system in Hungary is less attractive as a savings vehicle than those in the Czech Republic and Slovakia, it is not expected to be as expensive. The Hungarian regulators did not want the building societies to count as much on "good brothers" who would not take a loan. Thus, they limited the combination of loan term and size to less than the norm in Germany and are also requiring the building societies to retain more of their early profits as reserves.

Even so, Hungary's building society scheme is still likely to be popular enough to become a major part of the overall housing subsidy budget. This popularity may be because of the higher subsidy value of the loan component in Hungary than elsewhere, for two reasons. First, the market rate on a housing loan was running between 22-32 percent from 1989 to 1999, making the value of paying only 6 percent on a building society loan higher than in the Czech Republic and Slovakia, where market loan rates have been 10-15 percent. Second, even if a loan is not really needed, taking one will

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[61] 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 building societies started up.

allow retention of other funds in other forms of savings, the return on which has been over 12 percent.

As in the Czech Republic and Slovakia, no aspect of the building society subsidy is automatically adjusted for inflation. This has two major impacts. Because inflation has continued to come down, the 30 percent premium currently provided in the law produces an effective return (16 percent) that greatly exceeds what is available on bank deposits or even government bonds (12 percent for three years). Moreover, both the real amount that can be saved under the program and its value relative to housing expenditures will be larger than expected if inflation continues to decline rapidly. Thus, the impact of Hungary's building society scheme will partly depend on the course of inflation.

The extent to which building societies ultimately replace OTP and other universal banks as the main sources of housing finance is an important issue.[62] At this point, significant displacement appears likely. This conclusion is based on two observations. (1) The loan amount used by most households to buy a house in Hungary is low, because of the relatively low cost of existing housing and the already high equity levels of most potential home buyers (92 percent are owners, usually with little debt), and (2) there are no subsidies to non-building society financing, other than a 4 percent interest subsidy for new houses. Early evidence already supports this conclusion. In 1998, the first year of general availability, 21 percent of the unsubsidized loans made by OTP were "in advance" of a building society loan. The likelihood of displacement is a worrying development, because the building society system is a distortion in the financial system and is a less efficient way of delivering a subsidy compared to the direct approach that has been traditional in Hungary.

INSTITUTIONS: MORTGAGE BANKS

Hungary finally enacted a mortgage banking law in April, 1997, after several years of refinement and debate. During the law's development, the government had joined with several banks to sponsor creation of a mortgage bank, called the Land and Mortgage Bank. Thus, even before the law, a mortgage banking sector existed and considerable work had been done on how it should operate.

The original motivation for a mortgage bank system in Hungary was not the housing sector—which had long been served by OTP and was not perceived as needing more funding—but the need of farmers to obtain credit using their land as

[62] There is no doubt that the volume of building society lending will be far greater than bank lending, but most of it will be additional, i.e., it would not have taken place without the subsidy to 6 percent. The question is how much of this lending will supplant bank lending that would have occurred at close to market rates.

collateral. This is an even more sensitive issue politically than the housing sector. However, now that the legal and institutional structure is in place, it can be used for housing as well.

The mortgage banking legislation closely follows the German model, requiring that the banks be set up as separate institutions, with a large minimum capital balance and a separate supervisory structure. Such an arrangement has proven impractical in the Czech Republic and Slovakia; time will tell if it is truly feasible in Hungary. In keeping with the view that the classic German mortgage bank is a "superior" way of intermediating funds from the capital market, and not primarily an excuse for subsidizing a sector, the legislation did not provide any advantages for or subsidies to mortgage banking over deposit-based finance. Mortgage bonds are tax-exempt, but so are all bonds and savings accounts at this point. However, politics was already intervening and a special subsidy was likely to be granted just to the government-owned mortgage bank by the end of 1999.

MORTGAGE DESIGN

Even though some competition with OTP has appeared since 1997, about 85 percent of all housing lending is still done by OTP, which still primarily determines the choice of mortgage design.

Essentially only two choices exist. Most borrowers choose the traditional variable rate mortgage (VRM) design, despite the mid-1999 interest rate of 22 percent. These are underwritten to a maximum payment-to-(net) income ratio of 33 percent. At such high interest rates, the maximum loan-to-value ratio of 80 percent is rarely a limitation. The typical borrower can carry a loan for at most US$ 5-7,000, about 25-35 percent of the cost of a modest existing flat. The actual average loan size for these standard VRMs is only about half this maximum, suggesting the aversion of most borrowers to borrowing even that much.

The major alternative to the traditional design is the Deferred Payment Mortgage (DPM). As noted above, this is a seemingly simple design, whereby a payment interest rate is set (generally at 15 percent) and the difference between that payment and the payment due at the full market rate (22 percent, but formerly 28-32 percent) is deferred. Periodically, a new payment is set that will amortize the loan over the remaining term.[63] In effect, the DPM allows the bank to choose how much capitalization of the inflation

[63] Many observers have difficulty understanding how the loan will amortize over the initial term. But it is forced to by the design. For those familiar with inflation indexed mortgages, the easiest way to understand the DPM is to recognize that, if the difference between the payment rate and the market rate is equal to the full inflation rate, the loan designs are the same. Essentially, the DPM permits cutting back from the full capitalization of inflation, and will generally cause a large enough decline in the real payment burden over time to not require the complexity of indexing the payment by wages, as in the Polish DIM, to protect borrowers.

premium to permit and avoids the need for the customer to understand how price and wage indices are being applied.

In applying this mortgage design, OTP made two important adjustments. It accounted for the presence of a 4 percentage point subsidy over the first five years of those loans made for new housing, by setting the payment interest rate at 10 percent for such loans—5 percentage points lower than for other borrowers. Second, it set the maximum payment-to-income ratio at 25 percent for DPMs, instead of the 33 percent for most other borrowers, because payment burdens will decline much more slowly than for a conventional VRM. Although the net effect is to substantially reduce the ability of this design to expand maximum loan affordability, most borrowers would still find that they can increase their loan size by 25-50 percent over a regular VRM. In fact, the average DPM is over US$ 5,000.

The DPM design was initially strongly resisted by OTP staff and customers. This seemed to reflect difficulties accepting that the loan would actually amortize to the originally set term. But, extensive educational efforts have not significantly increased its use.[64] Rather, it has become apparent that most Hungarian borrowers do not want what the DPM offers, i.e., a chance to borrow more and for a longer term than with a VRM. The reasons are undoubtedly complex, but the most important may be that the spread between OTP deposit and loan rates has been around 10 percent, and Hungarians do not want to pay such a high spread any longer than necessary. In any case, given the evidence noted above that Hungarians are not borrowing as much as they qualify for with a VRM alone, it should not be surprising that a DPM does not hold great attraction.

No lender has offered loans denominated in a hard currency, despite inflation of 20-30 percent a year most of the time since 1990 and the successful application of scheduled depreciation in the forint. As will be noted below, a hallmark of the Hungarian housing finance market has been how few households really want to borrow unless borrowing conveys significant subsidies.

SUBSIDIES

The evolution of housing subsidy policy was outlined above. The current subsidies are discussed in greater detail here.

[64] What has affected its usage is a subsidy scheme (explained below) that grants maximum benefits for many participants borrowers only if they build up a large nominal loan balance over time.

Lump-Sum Subsidies

Hungary is the only CE country to have a tradition and current practice of offering lump-sum, cash subsidies for new housing construction. From 1971 to 1994, this subsidy was called the Social Policy Allowance (SPA), to highlight its connection to population growth policy. Receipt of such a lump-sum subsidy has always required the presence of at least one child. Large extra amounts for the second and third child are what made this an extension of population policy.

In late 1994, the name was changed to Housing Construction Allowance (HCA), the subsidy amounts were increased, and the program was restyled as a counter-cyclical subsidy to boost housing construction. The HCA for two children was raised from HUF 300,000 to HUF 1.2 million and for three children from HUF 900,000 to HUF 2.2 million. The new amounts translated into US$ 10,000 and US$ 18,000 respectively as of early 1995. The motivation was not just the relatively low level of housing completions in 1993 and 1994, but also the scheduled end to the partial VAT exemption. In fact, it was argued that the budget cost of raising the SPA/HCA would be largely offset by the withdrawal of the VAT exemption.

The boost had a major and immediate effect on housing construction activity. There appear to be two reasons for this. First, there already had been an upsurge in housing starts to benefit from the VAT exemption before it expired. Second, concentration of the subsidy into the two larger family sizes suddenly created a large pool of families for whom the HCA would cover one-third to two-thirds of the out-of-pocket cost of a modest new house in the Budapest area, and even more in rural areas. In response, many houses were begun in 1995, not because of any pressing need for additional housing but rather to cash in on a subsidy that was far greater than the annual income of many households.[65] In fact, the bulk of the HCA distributed in 1996 probably went to large families residing in poor rural counties, areas that had excess housing to begin with.[66]

The cost of the lump-sum subsidies jumped from 0.3 percent of the budget in 1993 to 2.0 percent of the budget in 1995. Housing activity increased rapidly (there are no data on starts but permits jumped) and completions were 34 percent higher in 1996 than in 1994. In principle, this expansion in activity might have been accompanied by an expansion in lending, despite the larger lump-sum subsidy. Quite the contrary. Since

[65] It is true that the subsidy had declined in real value since 1989 by about 50 percent, but these increases put it twice as high as at any previous time, and seemed to have transformed it from a supplement to increase affordability for a needed house into a potential major increase in family wealth.

[66] An indication is that one of the poorest counties in Hungary, Szabolcs, received 25 percent of the HCA in 1996 with only 5 percent of the population. The excess of existing houses is evidenced by the increase in the number of demolitions, which was almost as great as the increase in completions. There is even anecdotal evidence about contractors inflating construction costs and people "demolishing" their old house to qualify.

the HCA was introduced, the real amount of OTP lending for new housing has shriveled. In 1998, no more than 2 percent of the total costs of all new houses was financed by an OTP loan, while the HCA covered about 12 percent.

HCA eligibility was tightened in May 1995 and its nominal amount has not increased since its introduction in 1994. Thus, in 1998, its cost declined to less than 1 percent of the budget for the first time since 1995. The new government reinstituted a partial exemption from the VAT in 1999 to give housing a new boost. It is also studying the possibility of creating a lump-sum grant through local government, eligibility for which would be less closely tied to the number of children in a household.

Mortgage Subsidies

The subsidy reform in 1994 eliminated all subsidies to housing loans in Hungary except to individuals buying new housing. The basic subsidy is a 4 percent buydown for the first 5 years, followed by 3 percent for the next 5 years and 1 percent for years 11-15. The maximum amount eligible for the subsidy is HUF 1.2 million (US$ 5,000), more than most borrowers take out. Because of the high interest rates, the present value of this subsidy is not much less than that of the 4 percent permanent buy-down on loans in the Czech Republic. Notably, neither subsidy has seemed deep enough to provoke large-scale borrowing in the face of even modest net real market interest rates.

Tax Subsidies

A commonly held view in Hungary is that mortgage payments should be favored by the tax code, as they are in developed countries such as the United States and Western Europe. So far, because of budget concerns, such tax subsidies in Hungary have been very limited.

The current tax subsidy provision is called the Housing Loan Repayment Credit, which goes beyond the interest paid on a loan to permit a credit based on all amounts paid on qualifying loans. Basically, the same requirements for getting the 4-3-1 buydown subsidy apply, principally that the loan be for new housing. The subsidy takes the form of a 20 percent credit, rather than an open-ended deduction at higher tax rates. And, it applies only to loans made after December 31, 1993, since it was intended to compensate partially for elimination of the deep repayment subsidies on loans after that date.

This credit has a maximum of HUF 35,000 per taxpayer, which in 1994 was worth about US$ 350. Because the maximum benefit occurs only with repayments of HUF 175,000, most loans are not large enough to reach this level; the average claim in 1995 was only HUF 15,000. Even though the aggregate cost to the national budget in 1999 is estimated to be only 0.04 percent, it constitutes a significant reduction in the after-tax cost of mortgage borrowing. At an interest rate of 22 percent in 1999, a loan

term of 10 years, and an average size loan, this provision and the 4-3-1 subsidy result in an effective repayment over the first years that implies a nominal interest rate of only 12 (a real interest rate of about 2 percent). Despite that, only about one out of six buyers of new homes takes an OTP loan of any kind.

Building Societies

As noted above, Hungary's building society scheme has so far been oriented primarily towards attracting those with an interest in taking a loan, not as a source of superior return on savings. It grew very quickly in its first year, and is likely to become a significant, though not dominant, part of the overall housing subsidy structure. In 1999, expenditures on state premiums are forecast to be about 0.3 percent of the total budget. It is too early to tell what the eventual budget burden will be.

As noted in the Czech and Slovak cases, the total flow of subsidies can become quite large. This may seem odd when one calculates that the annual subsidy per participant is only US$ 100-150. It is the mass distribution of this small per person subsidy over 10-30 percent of the population that makes the building society system so expensive.

New "Social" Rental Housing

There has been some discussion in Hungary about the usefulness of expanding the supply of "social housing." But, no consensus has been reached on how to structure or fund this or even whether it makes sense to get the government back into the rental housing business in a big way. A housing allowance system already exists in Hungary. Thus, in theory at least, a desire to subsidize rental housing for the lower income groups could be met by offering housing allowances for private rentals.

VAT Subsidy

In striking contrast with the other CE countries, Hungary does not have a lower VAT rate for housing construction. Housing was initially exempt from the VAT, but that exemption was later limited and finally abolished in 1994. However, the partial exemption was reinstituted in 1999, for the same nominal amount as in 1994 (and thus only half the real cost). This will provide for a refund of 60 percent of the VAT, but only up to HUF 400,000 (less than US$ 2,000). It acts, therefore, as a lump-sum housing subsidy, with marginal investments in housing facing the full VAT rate.

Combining Subsidies

Table 3-3 indicates the 1999 magnitudes of funding for these various subsidies. It is notable that Hungary has the lowest share of current housing subsidies in its budget at the moment (although HCA itself had been 2 percent of the budget for a while). The

share will rise in the next few years, as subsidies to building societies increase and the new government's plans to introduce additional subsidies are implemented. But, it looks at the moment as if Hungary will avoid a new round of the sorts of deep subsidies being used to boost housing construction in the other three CE countries.

TABLE 3-3
MAJOR SUBSIDY PROGRAMS, 1999 (affecting current market for housing finance)

Program	Budgeted Amount (HUF Billions)	Number of Units	Amount per Unit (HUF)	Targeting
Housing Construction Allowance	22.0	14,000	1,625,000	New Housing, 2+ Children
VAT Exemption	12.0	30,000	400,000	New Housing
Building Societies	8.2	350,000 contracts	23,000 per contract	All Housing Related
Mortgage 4% Subsidy	0.6	?	?	New Housing
20 % Tax Credit on Repayments[a]	1.1	55,000	20,000	New Housing
Total	43.9 (1.4% of Budget)			

Note:
a The only data on this is for 1995, two years after the provision began. Now that four more years have elapsed, the number of eligible loans is assumed to have grown proportionately and the average amount claimed to have stayed the same.

In spite of the general reluctance of Hungarian households to borrow much for housing, a significant group of households can sharply reduce the cost of housing by combining the subsidies available. Take, for example, a household with three children and an income of HUF 100,000 a month, an income typical of house owners. If they are in the market for a new 60 square meter flat costing HUF 6 million, they are entitled to a full HCA of HUF 2.2 million (as long as they have not previously bought a new home) and a 4 percent subsidy on any loan they take out. Their income level entitles them to a maximum loan of about HUF 1.7 million. The present value of the 4 percent subsidy is about 12 percent of the loan amount, HUF 210,000. In addition, the loan repayments up to HUF 175,000 are subject to a 20 percent tax credit, for further savings of HUF 35,000 a year. The present value of this amount is about HUF 160,000. Thus, the total present value of the subsidies currently available to this family is about HUF 2.6 million, 43 percent of the cost of the flat.[67] A family with two children would benefit from subsidies worth HUF 1.6 million, still over 25 percent of the house price.

[67] It is unlikely that a family with three children will be buying a flat of only 60 square meters. In practice, rural households, with large families and options for self-building inexpensive family houses, have been the predominant users of the HCA and have enjoyed effective subsidies of 50 percent or more of their housing costs.

In a few years, these subsidies will be supplemented with access to 6 percent loans from building societies. The real values of all of these subsidies at that time will depend heavily on inflation and any revisions in subsidy policy.

OTHER FACTORS AFFECTING THE HOUSING FINANCE MARKET

In addition to the past and recent history of housing policy, the institutional structure of the housing finance sector, and the subsidies that help shape the market for mortgage finance, a number of other factors affect either the demand for finance or its supply (i.e., the willingness of lenders to make loans).

Demand Factors

Usually, the single most important factor affecting the amount of mortgage finance activity is how expensive it is to borrow long-term funds. Inflation and the general real interest rate on funds determine the general cost of funds (i.e., to the government). The actual cost to would-be borrowers is this rate plus a margin for the lender to cover costs, risks, and profits.

Nominal and real mortgage interest rates have been relatively high in Hungary. After sinking below 20 percent in 1994, inflation rebounded to 28 percent in 1995, returned to below 20 percent in 1997, and went below 10 percent in 1999. Despite these sharp swings, the principal mortgage interest rate charged by OTP remained between 25 and 32 percent for most of the period, with periods of low real rates punctuating longer periods of relatively high real rates. OTP has a general policy of not changing its rate frequently. It also has an extra incentive to keep its rate high, since the bulk of its portfolio are older loans on which the government pays most of the interest.

OTP did not face any price competition until very recently and is presumably using its market dominance to obtain above-market returns on its mortgages. However, the public has responded by reducing its borrowing in general and by rapidly repaying earlier loans at the end of the initial deep subsidy period. Nominal rates have also been high, which can be expected to further reduce demand.

It is not clear, though, how much higher the demand for financing would be if real and nominal rates were lower. OTP has offered the DPM since 1994, which (1) reduces the effective nominal interest rate to 10 or 15 percent while keeping the real rate the same and (2) permits up to a 50 percent increase in maximum loan affordability. Despite these advantages, it has been used mostly by buyers of new houses who want to maximize their access to the HCA (see below for more on this). This reluctance to use the DPM may result from an interaction with high real rates, since the DPM

essentially spreads out the real repayments on the loans, thus exposing the borrower to the effects of high real rates for longer.

However, the real rates on loans for new housing are much lower (only about 1-2 percent), because of the interest subsidy and tax credit. Even so, no more than 20 percent of new home buyers take out a loan.

Table 3-4 reports on loans approved by OTP by purpose and subsidy status.[68] As discussed above, lending was high from 1989 through 1993 because of deep subsidies. Presumably, the much lower use level in 1998 reflects the fact that the financing subsidies no longer reduce the real rate to less than zero. (It partly also reflects the increased lump-sum subsidy.)

TABLE 3-4
NUMBER OF RESIDENTIAL MORTGAGE LOANS APPROVED

Year	Inflat-ion	Inter-est Rate	HUF/ USD	# of New Homes Completed	# of New Homes Financed	$ for New Homes ($ Mil.)	# of Exist. Homes Financed	$ for Exist. Homes ($ Mil.)
1992	23.0	32.0	79.0	25,800	14,334	97.3	19,467	74.4
1993	22.5	28.0	92.0	20,900	11,278	73.5	22,457	82.6
1998	16.0	25.0	215.0	25,000	2,812	11.5	4,489	11.9

About 11.2 percent of buyers of new homes took out a regular loan from OTP in 1998,[69] a rate that is probably higher than that for buyers of existing homes. Precise data is not available for the number of transactions for existing housing, but a good estimate is 85,000, of which the 4,489 units financed accounted for only about 5 percent.

Even these modest figures for new houses are misleading, however. Many buyers of new housing were eligible for a large additional HCA if they had a child in the near future. But, the additional allowance could be retroactively applied only if the family had a loan outstanding from the transaction, and only up to the amount of that loan principal. This prompted qualifying buyers of new homes to take out a loan and then use the DPM design to take out a larger loan. In this way they ensured that the

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[68] The full array of loan types and purposes is far more complex, but this table indicates the general trends over the covered periods. The years 1994-1996 are not covered because OTP did not track its loans according to comparable parameters in those years. In all years, the figures exclude loans made as part of the "youth contract savings" program, which is insulated from market conditions, and also subsidized loans funded by employers and local governments but administered by OTP.

[69] This does not include 708 loans made for borrowers grandfathered under the closed deeply subsidized “youth contract savings” program, nor about 1000 loans deeply subsidized by employers or local governments.

nominal principal amount would grow over time, not shrink. Over a third of the loans taken by buyers of new houses were DPMs, mostly for this reason (only 3 percent of the loans for existing housing were DPMs). Without this quirk in the subsidy rules, the loan use rate for new housing might have been well below 10 percent.

All this strongly suggests that the low use of housing finance in general was not a result of high real interest rates, but rather the fact that even loans for new housing did not convey a net positive income gain. Only when loans have conveyed such a gain—such as generally in 1993 or for low-rate loans made by employers in 1998 or the 50 percent repayment subsidy on "youth savings loans"—is loan demand high.[70]

Supply Factors

Despite what appear to be large gross margins for OTP lending for housing, OTP does not consider housing loans to be very profitable. This is partly because of the high staff time involvement, since OTP staff has traditionally been relied on by the public to counsel them on the intricacies of housing loans, and to work with them on repayment difficulties. But importantly, OTP has experienced serious delinquencies on its housing portfolio and has been burdened with the great difficulty of recovering on loans made before legal and regulatory changes facilitated foreclosure, eviction, and sale on defaulted properties.

OTP benefits from a government guarantee on housing loans it made prior to 1989 and on most loans it has made since 1993 for new housing. The default rate on the older loans has been surprisingly high, considering that inflation has deflated the real repayment burden. However, the absence of underwriting standards at the time and political pressures to make loans generally available—combined with the borrower view that loans were entitlements and with a rise in the applicable interest rate from 3 percent to 12 percent—has apparently created a significant cohort of defaulted properties on which legal procedures have been exhausted and borrowers face dispossession, even if not eviction. This has brought claims by OTP for reimbursement by the government to high levels and the political fallout from dispossessing borrowers to political prominence.

This situation highlights the continuing concern of lenders about the political feasibility of collecting on housing loans, now that most major barriers to expeditious foreclosure and sale have been removed.[71] Lenders do appear to be willing to move ahead in this area, but they are factoring in a significant margin for potential default

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[70] A good example of the reverse process is the decline in the number of loans made for home renovation, dropping from 71,000 in 1993 to less than 5,000 in 1997 primarily because the 30 percent repayment subsidy was removed.

[71] The major remaining legal/technical barrier is the eviction execution process after foreclosure. A committee of involved parties is trying to resolve these remaining issues.

losses. If greater assurance can be achieved, it may be possible for lenders to reduce their margins and also relax underwriting standards.

The most critical missing element on the supply side in Hungary, however, is an environment of aggressive competition, such as exists in Poland and the Czech Republic. Although many banks have noted the need to develop a larger presence in the retail market, only two significant competitors to OTP have emerged. Fear of defaults is not a sufficient explanation, since gross margins appear large enough to cover even a 5 percent cumulative loss rate. A more plausible explanation may be an apparent difficulty in luring retail accounts away from the well-entrenched OTP. The growing signs recently of greater competition are encouraging in this regard.

CHAPTER 4

POLAND

Population: 38.5 million (1995)
GDP: PLN 551 billion (1998)
State Budget: PLN 142 billion (1998)
Exchange rate: PLN 3.5/USD 1.0 (1998)

BACKGROUND

Housing Finance Under Socialism

Poland is by far the largest of the four Central European countries, with a population of over 38 million (larger than the other three combined) and a housing stock of about 11 million units. Poles have a slightly lower GDP per capita than the other three CE countries, but have raised it more rapidly since their economic recovery began. The housing situation and housing issues facing Poland are generally very similar to those facing other CE countries.

During the Socialist period, the emphasis was initially on the production of state- and enterprise-owned rental flats and later on co-operative owned and managed flats, some of which were considered to be rented from the co-operative and others viewed as owned by the resident.[72] Throughout the Socialist period, however, the possibility of obtaining a owner-occupied family house remained, if one could procure the needed land and building materials.

As of 1990, the overall housing stock of 11.4 million units was distributed in the following manner:[73]

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[72] One distinctive difference from Czechoslovakia co-ops was the possibility of being either an owner or a renter in a co-operative. Almost every co-op had some of both types, and even in one cooperative building there were apartments of both types. There were two main distinctions between them: (a) rights to the apartment (much more extended for private owners) and (b) cost of purchasing an apartment (higher for owners). Despite this, even currently, tenant and owner co-ops housing units are still cooperative property, not cooperative members' property. Owners in co-ops are the owners of the rights to the apartment only.

[73] Data is from Hegedus, J.; Tosics, I.; and Mayo, S., "Transition of the Housing Sector in the East Central European Countries," Review of Urban and Regional Development Studies, 8, 1996, supplemented by data from "Report on the Status of the Polish Housing Sector," by Amy Hosier, Hanna Matras, and Christopher Banks, Urban Institute, June 1995.

Housing Unit Status in 1990:

Owner-occupied:	
Family Houses	40 %
Co-operatives	13 %
Rental:	
Public	18 %
Employer	12 %
Co-operative	14%
Private	3 %

Construction of state-owned units had been cut back sharply, to less than 3 percent of new construction. Enterprise-owned rentals had also declined but still accounted for 11 percent of new units. Co-operatives, both rental and owner, were the principal form of new housing, especially in urban areas. New family homes made up another 35 percent of the new units, mostly in the rural countryside.

In contrast to the public rental flats, only one-third of the cost of a new co-operative unit was paid out of the state budget as a grant. Another 10-20 percent was financed by a cash contribution from the would-be residents. Yet another 10-20 percent came from in-kind contributions by local government for land and central government for infrastructure. The remaining amount was covered by a loan to the co-operative by the state savings bank, PKO-BP, which was legally a department of the National Bank of Poland. These loans were for 40-60 years at a fixed interest rate of 2 percent.[74]

Owner-occupiers building family houses also had access to long-term financing from the PKO-BP, at 2.7 percent, usually for 40 years. However, the amount that could be borrowed on these terms was limited to the same amount as for a co-operative flat. Such households were on their own to complete the financing through sweat equity, cash savings, and remittances from relatives abroad, which were substantial.

All municipal and enterprise rents were set administratively at nominal levels and maintenance shortfalls existed from the beginning. Co-op “rents” were set higher, to actually cover regular maintenance and the (subsidized) repayment of capital through amortization of the PKO loan. The main explicit subsidy was on utilities, which has since disappeared.

[74] Since Poland was experiencing some inflation even before the transition, interest rates on savings deposits with PKO were paying 10-20 percent, creating a large shortfall on interest on these loans even then. This also meant that the present value of repayments on a co-op loan at 2 percent interest in Poland was much lower than on the 1 percent co-op loans in Czechoslovakia.

Initial Adjustments[75]

The initial transition adjustments in Poland from 1990-1995 were substantially different from those of the other CE countries. This was partly because of the higher inflation in 1989-1991. One hundred Polish zlotys at the beginning of 1989 were worth only 2.5 zlotys by the end of 1991, three years later. Most housing finance was quickly "indexed" for inflation as a result. Also, the government made huge outlays to buffer the housing sector from both inflation and the drastic economic decline during the period of "shock therapy."

The inflation made payments under the co-op loans originated before 1989 practically valueless after 1991, vastly reducing that component of the housing cost of co-op residents.[76] The real burden of these pre-1989 loans had to be absorbed immediately by the budget, which bore the difference between 2 percent received from the co-ops and over 100 percent paid on deposits in the PKO-BP.

In the other CE countries, most of what is known as the burden of the “old” loans relates to loans before 1989. In Poland, however, “old” loans includes some housing built well into the late 1990s.

The co-ops in Poland (which are essentially large building development and management enterprises, not a true co-operative of the residents of a single building) moved quickly in 1989-90 to make a large number of contracts to build hundreds of thousands of additional units. The question facing the state was how to finance (or to renege on) these contracts.

The approach adopted was to include in all loans made after 1989 a variable nominal interest rate related to market rates, and to set very low nominal payments that would increase over time. Specifically, the co-op paid 8 percent of the total interest due, the state paid a third directly, and the 60 percent unpaid was accrued and capitalized into the loan, causing nominal payments to rise over time. The amortization period was shortened to 15-20 years.

The bulk of the housing built until 1995 was financed under these terms, even though loan terms changed in 1992 (see below). This is the block of loans known as "old loans," with terms benefiting about 200,000 households. Already by 1993, the subsidies to these loans amounted to about US$ 458 million, 1.9 percent of the budget, making it the largest on-budget housing subsidy in Poland.

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[75] This discussion draws heavily on Brzeski, W. J., and Laszek, J., "Developing Mortgage Finance in Poland's Transforming Economy," *Housing Finance International*, March, 1996.

[76] Apparently, the real value of this debt was dissipated not only by the inflation, but also by a rapid prepayment of nominal amounts by co-ops in anticipation of indexation of debt amounts (see Brzeski and Laszek, 1995).

By 1992, the portion of the interest paid directly by the state had ended, as had about a third of the capital cost through a grant. Instead of being set at 8 percent of total interest, the repayments were set at 15 percent of household income (initially 25 percent but reduced under political pressure) with the expectation of being indexed over time to keep up with inflation-induced changes in income.

A peculiar feature of the switch to indexed loans in Poland is that about half the capitalized interest accruing on the loans was funded out of the state budget. In theory, these were loans to PKO-BP to maintain its liquidity in the face of rapidly rising nominal loan balances, which were still owed by the ultimate borrowers. However, the practice continued even after PKO-BP had no liquidity concerns, and many people expected the balances to be ultimately forgiven. Given that the government had authorized untenable repayment assumptions to begin with in order to enhance affordability, this expectation was inevitably rewarded by such a write-off in 1996. However, the basic construct of interest deferral and capitalization had become well established by then, even as interest rates had moderated below 40 percent.

For loans contracted for after 1992, construction lending for flats was differentiated from "end" loans and end loans were being underwritten and signed for by individual buyers of housing units. This was an important shift towards a more conventional mortgage loan market.

During this period, another type of loan came on the market—US$-denominated loans at a stated interest rate of 12-14 percent. These were relatively popular, and the higher income and more sophisticated part of the population was willing to accept the risk of changes in the real exchange rate.

Partly because of the continued availability of subsidies on the new "old" loans, construction of new housing did not fall off as rapidly in Poland as elsewhere. In fact, completions stayed steady right through the period of "shock therapy" and into 1993, when they finally started falling—from 130,000-135,000 units to 90,000 units, and eventually to 60,000-80,000 units. On average, the decline in housing construction was much less than in the other CE countries.

TABLE 4-1
COMPLETIONS OF HOUSING UNITS: 1989-1998

YEAR	# Of Units Completed (000)
1989	150.2
1990	134.2
1991	136.8
1992	133.5

YEAR	# Of Units Completed (000)
1993	94.4
1994	76.1
1995	67.1
1996	62.1
1997	73.7
1998	80.6

Poland was similar to the other CE countries, however, in that the decline in housing production was mostly in the directly or indirectly state-sponsored and subsidized sector. The portion of total completions in the family housing sector grew from 35 percent in 1990 to around 50 percent in the post-1993 period. Another significant shift came in the co-operative sector. Overall, it maintained a 40 percent share. But, so-called co-operative construction was no longer by the large, state-sponsored building companies. Instead, private development in the urban sector routinely took the legal guise of co-operatives, because this benefited the developer with lower transfer taxes and land cost. The completed units were often sold to non-members, usually for cash, and removed from co-op status. In this way, conventional private sector development came to encompass almost 90 percent of new construction.

Other aspects of the early transition were similar to those in the other countries. Ownership of the existing stock of state-owned flats (generally more than 20 years old and often pre-World War II) was transferred to the municipal governments, which were formally given responsibility for housing issues. Initially rent policy remained a central government prerogative and rent increases lagged behind inflation. In 1994, the government set a ceiling on rents of 3 percent of estimated replacement costs and left actual rent-setting to the municipalities. But few local governments responded by closing the gap between rents and even current maintenance needs. Rents remain low, and privatization in the rental sector has remained low in consequence.

Macroeconomic Evolution

Poland is famous for having been the most aggressive of the CE countries in pursuing a transformation to the private market. From 1989-1992, it underwent what was called "shock therapy", when subsidies were stripped away from enterprises and consumer goods, including utility fees, and extensive privatization of small enterprises was carried out.

As a result, the transition recession and recovery were telescoped in Poland, with real (measured) GDP collapsing by about 25 percent in 1989-1992, but starting to recover as early as 1992. Since 1994, Poland has enjoyed rapid recovery and rising real incomes, with the largest post-1989 net increase in real incomes of the CE

countries. This rise in real incomes has not translated into as much of a surge in housing construction as might be expected, however.

EVOLUTION OF HOUSING POLICY

More than anywhere else in Central Europe, Poland used the housing sector as a buffer against some of the trauma in the initial transition period (perhaps because that trauma was more severe). As noted above, large-scale construction of housing units continued, even though the burden on the budget was extraordinary. It is true that the construction of these units tended to benefit the relatively wealthy, since they stepped in to buy units when many households with high waiting list priority could no longer meet the increased requirements for cash payment and debt service. But this step also kept construction employment high during a time of deep cut-backs elsewhere.

In general, the early new governments, and reluctant Parliaments, have not moved quickly to shift to full market housing costs for the population. Even as early as 1992, when the terms of financing for co-operatives were hardening, the government added a lucrative tax incentive (discussed below) to encourage higher-income households to invest in new housing. Notably, though, after its expensive write-off of a large portion of capitalized interest on pre-1995 indexed loans, the government has not offered any subsidies to housing loans (unlike Hungary and the Czech Republic).

But nor has the government moved either to force the privatization of the existing rental stock or to push rents toward market levels. As noted, rents have been very slow to rise (partly impeded by the removal of subsidies from energy consumption) even enough to cover the cost of basic maintenance. This situation has left the existing rental population without incentives to move the stock towards a better allocation, to buy their unit or to invest in new housing for themselves and potential investors without incentives to invest in existing private rental housing (new rental housing is exempt from rent controls).

As in the Czech Republic and Slovakia, the government has also instituted a renewed effort to subsidize additional affordable units in multi-family buildings. It has done so in a more formal and sophisticated manner than is the case in the other two countries, through development of what is intended to be a long-term program of "social housing" not unlike that traditionally pursued in some Western European countries. This “TBS” system involves significant subsidy to "non-profit" development entities by the central government, and often by the local government as well, of about the same magnitude as the subsidy that was devoted previously to the co-operatives. However, there are income and house price restrictions and also an effort to ensure that "rents" are sufficient to cover at least short-term maintenance costs.

An attempt was made to develop a contract-savings system based on different principles from the German Bauspar system, but it has not proven very popular. A new system based on the Bauspar model was considered but may be rejected. Also in keeping with the other CE countries, the legal structure for a mortgage-banking system has been put in place.

Except for these latter efforts, pursued only relatively recently, a virtual vacuum of government intervention and subsidy in the private housing finance sector has prompted a flowering of offerings by private housing finance institutions. As of mid-1999, over 30 banks offer some kind of conventional mortgage finance. Although, for a number of reasons discussed below, the volume of new loans has so far been relatively low, it is rising rapidly.

The continuation of deep subsidies to new construction in 1990-1995 limited the decline in housing starts in Poland relative to the other countries but has also limited the bounce back from the lows. Reported completions in 1997-1998, for example, were near the depressed levels of 1994-1996. However, the number of units under construction has risen sharply (from 400,000 in 1994 to over 600,000 in 1999). This supports the common view that completion figures are being held down at least partly by tax incentives to delay any declaration of "completion".[77]

INSTITUTIONS: UNIVERSAL BANKS[78]

As in other CE transition countries, Poland started with a dominant savings bank (PKO-BP) serving the household saving and loan market and a dominant commercial bank (PKO-SA) drawing most of its funds through interbank loans from that savings bank. The Enterprise and Bank Restructuring Program was begun in 1993, with the goal of cleaning out the defaulted socialist-period debt and ultimately privatizing the housing finance sector. To compete with the two PKOs, the government set up four other large state-controlled but joint-stock commercial, as well as granted licenses to a number of small private banks and 14 foreign banks and joint ventures. As elsewhere, the bank privatization process has been fraught with delays and controversy, although it is now moving ahead strongly.

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[77] The incentive arises because each year the ceiling on the total deduction that can be taken for investment in a given house goes up by inflation, about 20 percent. If the unit is declared not to be complete, an additional deduction (say an extra PLN 20,000 when the ceiling goes from 81,900 in 1997 to 101,500 in 1998) can be taken the next year, and each year there after, as long as the ceiling is not reached in any given year.

[78] This section draws heavily on a report by Abt Associates for the Urban Institute Consortium, "Building on Progress: the Future of Housing Finance in Poland", March 1997, for USAID/Warsaw.

The stock of "old" housing loans resides in PKO-BP. The government also continues to purchase the capitalization amount on the indexed loans originated from 1992 to March 1995, although there are no apparent plans to write-off these funds. As of 1994, PKO-BP was making 95 percent of all housing loans, with the advantage of being able to offer an effective subsidy.

This situation has changed drastically in the last few years, however. Some other banks were offering competing mortgage loans as early as 1993. To facilitate and encourage this competition, the government, USAID, and the World Bank set up a refinancing window and technical assistance program in what was called the Mortgage Fund.

The Mortgage Fund was to be a versatile vehicle for crystallizing development of the housing finance sector, including encouraging use of innovative mortgage designs and more modern construction financing techniques. Although its volume of activities was far less than expected (in keeping with the low overall volume of unsubsidized housing finance and sufficient liquidity in most banks), its activities did stimulate wide interest and build up extensive expertise in mortgage lending.

This, in turn, has resulted in expanding competition among universal banks since 1995, when subsidized lending by PKO ended. In 1993, only three banks other than PKO-BP were offering mortgage finance; by 1996 this number had grown to 18. As of 1999, the number of banks reporting some type of retail housing loan program was over 30. Although only 6 of these are building substantial portfolios, with the other banks not marketing the product aggressively, there is a perception in Poland that this competition is encouraging the growth in the housing finance market.

In 1996, about 40 percent of the zloty volume was originated by other banks, a quarter of which was by the Polish-American Mortgage Bank, which had started offering loans denominated in US$ in 1993. Rather than being a permanent change, however, this was due to temporary withdrawal of PKO-BP from the market as it developed a new mortgage product. Since 1996, PKO-BP appears to have reasserted its dominance by virtue of its retail access to the great majority of ordinary Poles and its offering of the lowest rates on DIMs.

The fragmentary data available[79] suggest that PKO-BP is now making about 80 percent of the loans. But, it now has only about 60 percent of the total loan value. This is because its average loan is much smaller, about US$ 10,000. Its competitors average over US$ 20,000. This suggests a clear specialization, with higher income urban households more frequently borrowing from banks other than PKO-BP.

[79] There are no public data on the volume on mortgage lending. The data referred to here, compiled from conversations with market participants, are meant to be indicative and not authoritative.

Presumably PKO-BP is making more of their loans for the purchase of existing units or renovation, as well as to more moderate-income households.

Table 4-2 indicates the estimated year-end stock of housing loans for 1997-1999 (projected). The number of loans originated each year is significantly more than the net growth in the outstanding stock, since many loans are paid off early.

TABLE 4-2
TOTAL OUTSTANDING HOUSING LOANS (zloty and foreign denominated) (at end of year)

	1997	1998	1999(proj.)
# of Loans	42,100	73,600	125,300
Amount (PLN bln.)	1.47	2.86	4.94
Avg. Loan	34,900	38,800	39,400

The annual estimated lending volume is growing steadily. Data compiled for a UIC study indicated that about US$ 185 million in housing loans had been made in total in 1996, over about 20,000 loans. An estimated 28,000 loans were made (25,000 by PKO-BP) in 1997, a rate that was 40 percent higher than in 1996. The estimated rate of originations grew by another 40 percent in 1998, to 32,000 a year, and the value of outstanding loans reached US$ 800 million. Another 50,000 loans are expected to be made in 1999, for a volume of about US$ 600,000 million—over three times the rate in 1996.

How large a share of the potential market is this? It is estimated that about half percent of the loans made by PKO-BP were for new housing, while most of the loans by competitors were for new housing. That implies that about 18,000 new housing units received loans in 1998. These 18,000 loans can be contrasted with a likely number of private housing starts of 80-90,000, suggesting that only slightly over one-fifth of new private housing units benefited from a loan. Comparing the number of loans for resales, about 14,000 less those loans for renovation, with overall resales of between 130,000 and 150,000[80] implies that perhaps one out of ten buyers of existing homes are using a mortgage loan.

[80] In Hungary, the available evidence suggests that the number of resales is at least twice the number of new construction units. Total housing sales in 1993, the only year closely analyzed, appears to have been about 7 per 1000 persons. Applying this ratio to Poland would suggest 270,000 house sales. This is an unrealistic figure, because Poland has an ownership rate that is about half that of Hungary's (depending on how one counts co-ops).

INSTITUTIONS: BUILDING SOCIETIES[81]

Poland is notable for currently having designed its own contract savings scheme for housing. Called the *kasa mieszkaniowe* (KM), it was established in legislation passed in October 1995. The KM system is motivated by tax advantages linked to the deposit of savings plus the offer of a below-market rate loan after completion of the savings period. It has had relatively little success, however, and is expected to be modified in 2000.

A second system—modeled on, and referred to as, the *Bausparkassen* or *kasa budowlane* (KB) system—was approved by the legislature in June 1997. It now appears that the KB system will be modified to follow some of the KM principles.

That KM system can be summarized as follows:

Main Act:	October 1995, first operations in 1996
Regulation:	National Housing Fund supervision of premium payment, National Bank of Poland regulation of the KM system, requiring that net income be retained to build up a liquidity reserve, but otherwise following conventional bank regulations.
Subsidy to Annual Savings:	30 percent of savings, up to PLN 4500, in the form of tax credits. Annual optimal savings of PLN 15,000 (about US$ 4,400 or seven times the size of the optimal savings of the Bauspar systems in the other CE countries).
Minimum Saving Period:	Three years, and three years to get housing contractual loan (initially savings were withdrawable at any time without loss of subsidy as long as a housing purpose could be demonstrated).

[81] Most of the factual observations, but not necessarily the conclusions, are drawn from a report entitled "Analysis of Contract savings Systems in Poland," by M. Lea, J. Laszek, and L. Chiquier, Urban Institute Consortium, March 1998, for USAID/Warsaw.

Other relevant aspects of the system:

(1) Interest on savings exempt from taxation,
(2) Interest paid on the loans not tax deductible,
(3) No provision for early bridge loans,
(4) Parameters of the state premium embedded in law, with Parliament having to change them,
(5) Banks expected to operate the system on a non-profit basis.

One of the most striking aspects of the KM system is that it was incorporated into the existing banking structure as a special product. Savers could open up savings accounts with existing banks and make deposits that would benefit from either tax deductibility (initially) or a tax credit (currently). As in a Bauspar system, the account would pay a below-market rate on interest and then make a loan at a below-market rate. As opposed to a Bauspar system, these rates were fixed not at specific levels, but as a percent of "market" rates. However, just as in a Bauspar system, there was some potential for the inflow of new savings to be too low to finance all the loan demand. In such a case, the law provided for either access to additional liquidity from the government-funded National Housing Fund or, if necessary, a delay in making some loans.

Why did the KM system fail to grow? The most likely reason is that it was designed to be operated on a non-profit basis—with all advantages from the "treasury" of below-market rate savings being recycled back into the system and the only profit being the spread between the loan rate and the savings plus a 1 percent service fee. This feature, combined with an original slant towards higher income households (subsidy depended on tax deduction), kept the major retail bank, PKO-BP, from participating in it. The only really active bank, PKO-SA, is a large bank dealing with higher income households. No institution has a big incentive to promote the system.

An additional reason for the low interest on the part of potential customers is that, originally, the only households attracted to it would be those that paid substantial income taxes, since the subsidy derives from income deductibility tax. In 1996, only 7 percent of all taxpayers (about 1.5 million) were above the lowest tax bracket and the initial design produced larger savings the higher the tax bracket. This distortion was remedied in 1997 by setting the reduction in taxes for all savers at 30 percent of the amount saved. However, this tax credit is not refundable, i.e., if one's taxes are less than the tax credit, one loses the excess credit. Thus, the attraction of the KM was still somewhat limited to those otherwise liable for significant taxes.

The KM system is likely to undergo modification in the near future, in order to broaden its popularity and impact. Thus, its final shape is still unclear.

INSTITUTIONS: MORTGAGE BANKS

As in the other CE countries, Poland is moving towards funding a share of its long-term housing loans through bonds issued by specialized mortgage banks. The legislation refers primarily to the classic design of the system in Germany, with separately capitalized entities engaging exclusively in a few lines of business and funding themselves nearly exclusively thorough bond issuance. This structure has yet to be tested for market viability in Hungary, but similar approaches have failed to be commercially successful in Slovakia and the Czech Republic.

In every other CE country, unattractive fundamentals (low business volumes, high need for minimum capital, high relative bond financing cost) have prompted strenuous efforts to obtain for mortgage banking a variety of subsidies and preferences. So far in Poland, the only subsidy bestowed is a more favorable order of claim in case of foreclosure. Unless additional advantages are materialize (which are not being recommended here), it appears to the author that mortgage banking is unlikely to be an important part of the funding for residential lending.[82]

MORTGAGE DESIGN

Partly because of the high inflation in 1989-1995, and partly because of the large number of universal banks entering the mortgage lending market, Poland has seen the widest variety of mortgage designs on offer. Poland was significantly ahead of Hungary in introducing housing loans in which principal was indexed for inflation and repayments rose over time in nominal terms. More specifically, the Dual Index Mortgage (DIM) design, in which the repayment moves with the level of wages in the economy, was adopted early on. The initial payment was expressed as a percent of income and the eventual loan term depended on how real wages moved over time. If real wages stayed constant, the expected term was expected to be 20 years.

The classic DIM was promoted by a coalition of donors, working through the Mortgage Fund (see above), which was to help banks finance the negative amortization inevitable with such loans. A variant on the DIM (really using the DIM as camouflage for a subsidized loan) was also offered from 1990-1995 by PKO-BP. The main difference between this and the DIM of the Mortgage Fund was that PKO-BP was underwriting the loan under assumptions that practically guaranteed it would not pay off within 20 years. Moreover, the government was directly financing a portion of the negative capitalization, prompting hopes among the loan holders that it would forgive this portion under future political pressure. Thus, the PKO-BP DIM was clearly more advantageous than the

[82] Mortgage bond issuance is more often useful for funding lending for commercial real estate by entities with restricted deposit bases.

"unsubsidized" DIM refinanced by the Mortgage Fund and it dominated the market (which was relatively small anyway) until 1995.

As of 1999, the main mortgage options are the classic DIM, the classic variable rate mortgage (VRM) and the foreign-currency denominated loan. A variant on the DIM, with a lower rate of deferral, is also offered by PKO-BP and is the most popular design. Banks vary in the loan terms they offer, with some not exceeding 5-7 years, most sticking to 15 years, but PKO-BP going to 20 years. All require a floating rate, usually unilaterally set by the bank according to its judgement as to the cost of funds and market rates. Most banks that make relatively few loans offer only the VRM design and only for relatively short terms.

As inflation continues to decline over time, mortgage banks will presumably be able to offer fixed rates for periods as long as five years. However, the prospects for permanently low interest rates have been somewhat dampened by recent experience with the volatility of capital flows in and out of emerging markets.

Mortgage interest rates in Poland are currently in the range of 16-17 percent, with the exception of the US$-denominated loans at 11-12 percent. These are relatively high real rates, since inflation is at 6-7 percent and generally declining. However, they reflect primarily high real rates in general funding markets and not a high lender margin. At such rates, the effective term of simple VRM loans is closer to 6-8 years, whatever the stated term. While many households stick with the VRM format, the bulk of loans made by PKO-BP use some type of deferral.

SUBSIDIES[83]

Despite the harsh discipline applied to the macro-economy as a whole during the transition, the governing forces in Poland have treated the housing sector very gently. The general perspective seems to have been that this was a sector vital to the mass of ordinary people, in which subsidies can go far in maintaining the political equilibrium and psychological morale needed to accept the rest of the reform package.

The largest housing sector subsidies have been associated with (1) keeping rents low in the rental stock, both public and private, and (2) funding completion of thousands of additional co-operative units in the face of a declining economy and spiraling prices and interest rates. But these are subsidies associated with the past. Our focus here is on the subsidies shaping the face of housing finance today. Table 4-3 below lists these subsidies and summarizes their relative importance.

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[83] This section draws upon the report by Sally Merrill, et al., "Final Report on the HUDA Report", Urban Institute Consortium, October 1998, for USAID/Warsaw.

Tax Subsidies

The principal public-benefit argument for subsidies in Poland has been the expansion of construction activity. On that line of thought, it was considered attractive to offer large tax concessions to relatively upper-income households to encourage them to buy or build new homes. The basic tax subsidy was put in place in 1992, just as support for co-operative construction ended. The original provision allowed taxpayers to deduct from their taxable income the cost of construction up to 70 sq. meters. This provision translated into a certain ceiling amount that has been indexed since then to the official average construction cost. For 1998, the ceiling amount was PLN 101,500.

Since nearly all new units cost more than this, the subsidy scheme has become a lump-sum deduction for those acquiring a new home. However, originally the actual value of the subsidy depended on the tax bracket of the household, which could vary from 15 percent to 44 percent, with the greater subsidy going to the higher income households. This provision was reformed in 1997 to specify a fixed bracket of 19 percent to be applied to these deductions—i.e., to convert the subsidy to a credit against taxes due rather than a deduction against taxable income.

Two other important aspects of this subsidy are (1) any amount that cannot be fruitfully applied in the given year can be carried over for up to three years and (2) additional investments made in the second or third year of construction benefit from the inflation-related increase in the ceiling amount. Any major additions to the new or existing housing also benefit from this subsidy. In addition, a lower is amount allowed for simply repair or renovation of an existing house or flat.

A number of such tax subsidies were estimated in the aggregate to cost the government about PLN 2.7 billion in lost revenues in 1996 (about 0.75 percent of GDP or about 2.7 percent of the total cash budget). This tax subsidy is substantially higher than exists in any other CE country (although the Czech Republic began to permit deduction of mortgage interest in 1998).

This subsidy scheme is notable for several reasons. First, it is entirely independent of formal sector mortgage finance. This is a plus from the viewpoint of economic efficiency, since it means that the subsidy does not rely on costly financial intermediation processes.

The subsidy is also notable for its unabashed focus on those with incomes (and thus taxes) high enough to take full advantage of it. This removes any residual claim that the subsidy is providing any direct "assistance" to those who need to meet minimal housing demands. Instead, the argument is that the social benefits of adding more housing accrue to the whole society and the only question is how to encourage the most additional stock for the least amount of funds. If the additional units are built entirely with state funding, as is occurring in Slovakia, little private funding is brought to bear.

But as long as private long-term finance is relatively expensive, only households with large cash resources are in a position to act on any incentive to build more housing. These tend to be higher-income households. Thus, if the social goal is to boost housing construction, a tax-based subsidy is desirable.

Of course, this begs the question of substitution: how many of the new units would be built even without the subsidy. It is at least arguable—with the subsidy structured as a deduction rather than a credit (as from 1992-1996), and the largest subsidies going to those with the highest incomes—that the bulk of it is going to those who would build a new house anyway. Why? Because those with extraordinarily high incomes, in the highest tax bracket, are very likely already to want more housing than they had under the previous economy, where few urban households had over 100 sq. meters. In this case, the primary effect of the subsidy is in upgrading the quality of the finish of the larger house (mostly with imported finishing) and is simply an income transfer to the rich.

How valuable is this subsidy? In 1998—as a tax credit worth PLN 101,500 times 19 percent (= US$ 5,670) to most new home buyers, with most new homes in urban areas costing more than US$ 50,000—the subsidy was worth only about 10 percent of the cost of a new home. This is significant as an income transfer to relatively rich people, but not as significant as the housing subsidy being provided by the new TBS system.

New "Social" Rental Housing

As in the Czech Republic and Slovakia, Poland has a major new subsidy program to expand the supply of below-market rental housing, known as the TBS system. But, the scheme is Poland is the most fully articulated—developed systematically to serve as a long-term mechanism for the rental sector, not just as a stop-gap means of expanding housing supply. The system is built around the notion of non-profit entities (TBS) (but including local governments (called gminas)) taking on the responsibility of constructing, owning, and managing a block of rental units. (TBSs can also add to their portfolio by taking over the rehabilitation and management of municipal flats.)

In return for these responsibilities, the TBS gets a significant capital subsidy (a loan from the government (through a government-owned bank) for 70 percent of the capital costs at only half the bank rediscount rate), as well as some equity investment from the tenants, and does not have to put up any equity itself. It must then operate under the burden of rents set at not more than 4 percent of "replacement cost" (the cost of building those units, adjusted over time for changes in construction costs).

On the positive side, this arrangement—with the state providing capital at a preferential rate of interest, the TBS or gmina contributing in-kind contributions of land

and maybe infrastructure, and the tenants adding up to 10 percent—can be attractive to all concerned, except maybe the state. The TBS or gmina adds units to the local housing stock at an explicit cost of only 20 percent of total cost. The tenants get a rent at about half of true cost[84] in return for lending up to 10 percent of costs, and even then the loan is indexed for inflation and refundable at departure.

On the negative side, the scheme is an expensive way of adding housing units. The present value of the state's contribution is about 35 percent of total costs, which is higher than its contribution to any other form of new construction, including through the tax subsidies. When the scheme was first formulated in 1995, the subsidies were too low to arouse enough interest. The scheme began to take off after the subsidy was enhanced in 1996, and is now forecast to reach about 6,000 units a year, over 8 percent of the new housing production—which would cost about PLN 1 billion per year, about 0.8 percent of the budget.

This arrangement seems to be fraught with mis-incentives and dangers, as are corresponding efforts in the other CE countries to add to the municipal-owned stock. The long-term nature of these non-profit entities is not clear. Are they capable of developing and managing complex real estate without charging a market rate of return for their efforts? It appears that 4 percent of "replacement cost" is not enough to cover long-term costs of operation. This may mean that the non-governmental TBS expect to be bailed out on their rehab expenses at a later time, and thus have no incentive to manage the property properly meanwhile. Do the tenants have any ability to "manage" the management? More generally, what are the rights of the tenants and how transferable are a tenant's rights to another tenant?[85]

Building Societies

As noted above, Poland's first effort to establish a construction savings scheme did not attract a significant number of participants. Thus, it did not cost the government much. The second scheme, modeled more closely on the German Bausparkassen system, is far more likely to be very costly if pursued as adopted. However, the government is attempting to moderate the structure of the KB model and also incorporate it into the regular banking system, as it did the KM system.

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[84] The real cost of capital to housing is on the order of at least 5 percent plus depreciation of 1-2 percent a year.

[85] There have been references to the notion that these units are intended to provide short-term options for young families and job mobility. If the idea is that somehow the tenants will voluntarily move after a few years without any side payment, it should be pointed out that the history of subsidized rental housing programs is not very promising in this regard. And that there is probably already quite an active gray market for communal, co-op and other kinds of rental units.

Mortgage Subsidies

Poland is unique among the CE countries in not having some form of subsidy for conventional mortgage finance, even for new housing. Nor does Poland offer state-sponsored financing at below-market rate. Other than under the Bauspar-type schemes, no housing assistance is delivered in the guise of housing loans on advantageous terms, nor are there tax advantages to borrowing for housing. This is a highly desirable situation from the point of view of not having people waste resources on administrative expenses just to access a subsidy that could be delivered directly. Nor has it seemed to discourage development of active competition in the mortgage lending business.

However, the Polish government is actively considering adopting a targeted interest subsidy in 1999. This new subsidy would largely replace the existing tax-deduction based subsidy for construction costs.

Subsidies to Mortgage Banks

As noted above, Poland is only now putting the finishing touches to a mortgage banking scheme. So far, the Parliament and the government have resisted efforts to grant special favors to home loans made by mortgage banks. However, if, mortgage banks turn out to be financially non-viable under current circumstances, as seems likely, there may be a renewed effort to grant them special assistance.

Reduced VAT Rate

The general VAT rate is 22 percent, but housing and other forms of construction bear only a 7 percent rate. The 15 percent differential probably constitutes another 10 percent subsidy to the cost of new housing, on top of all the other subsidies available to new housing, both public and private, rental and owner-occupied. (A more precise estimate of the subsidy size is not possible without further information about the enforcement of the VAT and the presence of special rates for other sectors.) It should be noted, that the government has announced its intention to reduce disparities in VAT rates.

TABLE 4-3
SUBSIDIES TO THE CURRENT MARKET FOR HOUSING FINANCE IN POLAND, 1998

Program	Budgeted Amount (PLN Millions)	Number of Units	Amount per Unit (PLN)	Targeting
National Housing Fund (TBS Rental Flats)	270	4,500	60,000	New, modest size, low-rent
Bauspars	NA	40,000 contracts		All Housing Related
Tax Deduction of	3,833[a]	1,000,000+		Mostly Investment in

Program	Budgeted Amount (PLN Millions)	Number of Units	Amount per Unit (PLN)	Targeting
Housing Investment				Housing Construction and Repair
Lower VAT Rate	NA			New Housing
Total	> 4,103 (>2.9 % of Budget)			

Note:
a In 1996, the loss of tax revenues from this deduction was 0.75 % of GDP. This percentage was applied to estimated GDP for 1998. However, the costs in 1998 were lower than this because the provision was converted to a tax credit in 1997.

Combining Subsidies

A major opportunity to combine subsidies may present itself if the Bauspar system starts. A couple currently making a high income (over PLN 40,000 a year) should be able to both take the tax credit for new construction and save in the form of two KB contracts. If they buy a house costing five times their income (PLN 200,000), they can claim PLN 101,500 for a tax credit of PLN 19,285. Since such a purchase would certainly require prior savings of over PLN 50,000, it should be easy to deposit about PLN 17,400 (in 1998 zlotys) cumulatively in each of two KB accounts over four years. At the end of this period, the couple will be entitled to a loan for about PLN 40,000 (combined accounts) for four to six years at 6 percent. If interest rates are the same as they today (about 25 percent), the present value of the subsidy embedded in the loan rate (for five years) is about PLN 14,000.

In this example, the present value of the total state assistance the couple will receive on their home purchase is about PLN 33,200, about 17 percent of the cost of the house. This is significantly less than the subsidy that used to be provided to purchasers of co-ops, but is still large.

OTHER FACTORS AFFECTING THE HOUSING FINANCE MARKET

In addition to the past and recent history of housing policy, the institutional structure of the housing finance sector, and the subsidies that help shape the market for mortgage finance, a number of other factors affect either the demand for finance or the supply (i.e., the willingness of lenders to make loans).

Demand Factors

The single most important factor affecting the amount of mortgage finance is the cost of borrowing long-term funds. Inflation and the general real interest rate on funds determine the general cost of funds (say to the government). The actual cost to would-be borrowers is this rate plus a margin for the lender to cover costs, risks, and profits.

Inflation has been trending down steadily since its peak in 1990. It had declined to 33 percent in 1994, 13 percent in 1997, 12 percent in 1998, and a possible 7 percent in 1999. Even this level of inflation would make nominal interest rates on conventional loans fairly affordable if the real interest rate on loans were lower. However, the spread between inflation and mortgage rates is about 9 percent, with market loan rates about 16 percent. Although this is a significant improvement from the spread of 12 percent in 1998, as in the other CE countries, the high real cost remains a powerful disincentive against long-term borrowing for housing.

It is notable that Poland was the first of the CE countries to attempt to spread the burden created by high inflation. The initial version of the DIM offered by PKO-BP not only eliminated the "tilt-effect" on the real level of loan repayments caused by inflation, but went further to actually subsidize the repayment down to an implicit real rate of only 6 percent. Since 1995, this subsidy has no longer been available. While borrowers can avoid the tilt effect through use of a DIM, they can no longer avoid the full real cost.

Compounding the problem of costly funds has been an apparent reluctance by borrowers to take on much of a repayment burden, especially one that might persist for more than a few years. This is reflected in the data on the loans funded through the Mortgage Fund, where the average payment-to-income ratio for DIMs in 1996 was only 17 percent.

Despite these problems, the demand for mortgages appears to have been as strong in Poland as in the other CE countries (or even a bit stronger). About 20 percent of Polish buyers of new homes use mortgage credit. In Hungary, where real interest rates were about the same in 1998, this figure is less than 15 percent. In the Czech Republic and Slovakia, despite significant subsidies and lower real rates, mortgage credit is used even less.

The region-wide experience is more thoroughly analyzed in the Summary chapter. The conclusion is that borrower reluctance is more of a factor than even the high real rates of interest in inhibiting the use of mortgage finance in Central Europe.

Supply Factors

Several supply-side factors are at work in Poland. The most significant, as in the other CE countries, are nagging concerns about recovering on defaulted loans. In

Poland, one of the most worrisome of these concerns was recently partly resolved. The mortgage lien used to be treated as fairly junior compared with several other claims against the house as an asset.[86] Under recent legislation, a mortgage when made by a mortgage bank was moved up to second rank, behind tax liens, and the government was required to actually disclose such a lien on the property if such priority is to be claimed. If mortgage banking is eventually integrated with commercial banking, as in the Czech and Slovak Republics, this should improve the overall situation.

Issues associated with registering the lien (due to lack of a centralized cadaster system and slow registration procedures) and with sale and eviction in case of foreclosure remain. The murky tenure of those "owning" their co-op unit is another issue. In particular, can a borrower adequately mortgage a right to live in a co-op unit in a way that can be foreclosed upon, sold, and the previous owner evicted?

Some of these are major issues, but lenders seem willing to take some risk in these areas currently. Presumably this risk is factored into the relatively high margins on mortgage lending.

Funding for long-term mortgages could also be viewed as a potential problem. However, as long as mortgage lending remains at relatively low levels it is not critical—especially for the major lender, PKO-BP, which has a huge and stable funding base of retail deposits.

[86] See Carol Rabenhorst, (on Statutory Liens), Urban Institute Consortium.

CHAPTER 5

SLOVAK REPUBLIC

Population: 5.5 million (1998)
GDP: Sk. 717 billion (1998)
State Budget: Sk. 197 billion (1998)
Exchange rate: Sk. 34/USD 1.0 (1998)

BACKGROUND

Housing Finance Under Socialism

The Slovak Republic (Slovakia) was part of Czechoslovakia during the Socialist period and shared with the Czech Republic, as well as with Poland, a policy emphasis first on state-owned rental flats and then on co-operative owned and managed flats. However, throughout the socialist period, the possibility of obtaining an owner-occupied family house remained, if one could procure the needed land and building materials. In fact, in the 1980s, about half of all new units were such family houses.

Slovakia is nearly as large as the Czech Republic, but has only half the population. Much of the country is mountainous, and flat developable land is scarce, especially around Bratislava. Its population is more rural, with 43 percent living in villages and only 25 percent in towns of over 50,000. Moreover, its population is also growing slightly (0.3 percent a year) in contrast to those of Hungary and the Czech Republic.

As of 1990, the overall housing stock of 1.8 million units was distributed in the following manner:[87]

Housing Unit Status in 1990:

Owner-occupied:	
Family Houses	50 %
Co-operatives	23 %
Public Rental:	27 %
Other Rental (mostly employer):	none
Private Rental:	none

[87] Data are from Hegedus, J.; Tosics, I.; and Mayo, S., "Transition of the Housing Sector in the East Central European Countries," Review of Urban and Regional Development Studies, 8, 1996.

At that time, although a significant number of state-owned rental units were under construction, co-operatives were the principal form of new housing, especially in urban areas. One-third of the cost of a co-op unit was borne directly by the state budget, another one-third by a cash contribution from the would-be residents, and the last one-third by a state savings bank loan to the co-operative, for 40 years at a fixed interest rate of 1 percent.[88]

As in the Czech Republic, owner-occupiers building family houses also had access to long-term financing from the state savings bank, at 2.7 percent, also for 40 years. Would-be house builders faced greater difficulties acquiring serviced land and building materials than financing.

The below-market financing available from the state savings bank was financed through a combination of low interest rates on deposits (and a monopoly position of the savings bank in this regard) and cross-subsidization on loans to enterprises.

Initial Adjustments

From 1990 to 1995, several important adjustments were made in the housing and housing finance sectors. New legislation provided for the transfer of most state-owned stock to municipal governments, privatization of that stock to sitting tenants, and restitution of pre-World War II rental stock (with sitting tenants at controlled rents). As in the Czech Republic, the amount of privatization during this period was quite small (about 2 percent of the public rental stock), presumably because the increases in rent on the stock were relatively modest and renovation needs high.[89] In contrast to the Czech Republic, relatively few units were subject to restitution, since the private rental stock was quite small as of World War II.

New production plunged sharply after 1990. Starts data were not compiled from 1992-1994, but even by 1991, starts had dropped 84 percent from 1990 (to about 6,000 units), a slightly sharper fall-off than in the Czech Republic. Data were compiled again after 1994 and show the same low level until 1996.

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[88] The net effect of this below-market rate was to reduce the present value of repayments by half, bringing the total state subsidy to half the price of the unit. Even so, since the co-op residents, in contrast to tenants in state rentals, were expected to pay for the full costs of the maintenance of their buildings, as well as service the debt, the net present value of the cost to the state of building co-ops was less than half of that of adding more state rentals.

[89] It should be noted, though, that official policy was for the price to be set at only about 5% of the replacement cost, which was supportive of privatization.

TABLE 5-1
HOUSING STARTS AND COMPLETIONS: 1989-1997

YEAR	# Of Units Started (000)	# Of Units Completed (000)
1989	35.7	33.4
1990	32.9	24.7
1991	5.9	20.8
1992	NA	16.4
1993	NA	14.0
1994	NA	6.7
1995	4.0	6.2
1996	6.4	6.3
1997	12.8	7.2
1998	16.9	8.3

Less funding was available for completing planned construction or even finishing partially completed public rental units then in the Czech Republic. As a result, completions fell further and faster, by 80 percent from 1989 to 1994, settling in the 6,000 range until 1998, when the upsurge in starts in 1996 and completions of unfinished buildings is expected to have boosted completions back over 10,000 for the first time since 1993.

As in the other CE countries, an immediate transition issue was the burden of subsidizing the outstanding low-rate loans on co-ops and family houses. The stock of old loans in 1995 was about Sk. 12.0 billion and the budget subsidy outlay was about Sk. 1.5 billion million, about 0.7 percent of the state budget. This is a substantial burden, as in all the other CE transition countries.

Macroeconomic Evolution

The recession in Slovakia that immediately followed 1989 was fairly severe (a net decline of 25 percent in measured GDP), but the recovery that started in 1994 has proceeded more strongly than elsewhere, with real growth hitting 7.4 percent in 1995. Growth has remained positive recently, although more muted. Direct foreign investment has been relatively low, apparently because of political uncertainties, but a strong export market has sustained economic growth

Inflation has also been relatively moderate, surging up to 60 percent in 1991 but declining to less than 10 percent since 1995. Despite a significant devaluation in the second half of 1998, inflation has remained low, running about 6-7 percent.

EVOLUTION OF HOUSING POLICY

The first non-Communist government did not make housing a high priority. Initially, no additional funding was provided for finishing panel flats in mid-construction, or any deep subsidies to households for home construction. Neither did the government move to force privatization of the existing rental stock or to push rents toward market levels.

As noted above, housing starts fell precipitously during the recession (as would be expected even in a well-developed market economy if jolted by a 25 percent decline in GDP). By 1995, faced with housing starts running only 20 percent of their previous level, the government started planning a State Housing Fund, which would channel low-rate loans to the housing sector. In addition, the government started to look closely at funding completion of unfinished panel flats.

But even before these initiatives were being debated, in 1992 Slovakia adopted the first Building Society scheme in the CE, modeled after the German and Austrian Bausparkassen. Most observers credit strong lobbying on the part of foreign Bauspar interests for this rapid action. As in the Czech Republic, the resulting system has been subsidized generously enough to have grown quite large, with over one-fifth of the population participating by 1999. Its operations are discussed in detail below.

At the same time Slovakia was considering adoption of a Bauspar-type system, it was also examining the German mortgage banking system. The final mortgage banking legislation was not inaugurated until 1996 despite active discussion since 1993. However, because there were no substantial subsidies to these sorts of loans, mortgage bank activity has been weak.

Faced with continuing low levels of housing activity, in 1995 government policy moved towards more immediate stimulation of housing construction, as noted. A large amount of funding, Sk. 2.0 billion (about US$ 62 million), was secured from the National Privatization Fund and plowed into finishing uncompleted municipal flats. In 1996, a State Housing Fund was set up to make low-rate loans directly to households. It started at a relatively modest level of Sk. 800 million for about 1000 units in 1996, but has ballooned to about Sk. 3.5 billion in 1998, with plans to go to Sk. 6 billion in 1999.

In contrast to the situation in the Czech Republic, the general economic recovery starting in 1994 had not stimulated housing starts significantly. Housing financed by the State Housing Fund appears to account for most of the sharp recovery of housing starts to 12,700 in 1997, with approvals under that program alone providing for 7,000 units in 1997 and 1998.

In addition to this recovery in the new construction sector, significant progress has been made since 1994 on "marketizing" the previous stock of municipal housing. Unit prices have been set very low and as of 1998 it appears that about 40 percent of them have been privatized, up from the 2 percent as of 1994.

INSTITUTIONS: UNIVERSAL BANKS

As in the other CE transition countries, Slovakia started with a dominant savings bank—already named Slovenska Sporitelna (SLSP)(Slovakian Savings Bank)—serving the household saving and loan market, and a dominant commercial bank, the Czecho-Slovak State Bank, drawing most of its funds through interbank loans from the SLSP. The State Bank was then split into the Vseobecna Uverova Banka (VUB) (General Credit Bank) and the Ivesticna a Rozvojova Banka (IRB) (Investment and Development Bank). The stock of old, low-rate loans for family houses resides in SLSP and the loans to co-ops in the IRB. Both receive a flow of subsidies from the government to bring the return on these funds up to the Central Bank's discount rate. Even as late as 1996, the SLSP, VUB, and IRB together held 75 percent of all the liabilities in the banking system and the SLSP, with about 50 percent of all deposits, was a large net lender to the rest of the sector.

Although many foreign and new private banks have started operations, they have not significantly changed the complexion of the banking sector. Moreover, the bank privatization process has been very slow, as has the privatization process in general in Slovakia. The VUB and IRB were subject to voucher privatization. But this failed to introduce strong corporate governance and additional investment. The SLSP remains fully government-owned but may be privatized soon. (One interesting side effect of the situation was that the introduction of a limited amount of formal deposit insurance was met by public indifference, since the public had simply assumed that deposits in all government-controlled banks were already government-insured.)

The Slovak retail banking market has been dominated by SLSP. SLSP continued making housing loans on the old terms of 2.7 percent for 30 years through 1992, in which year 13,400 loans were made for Sk. 1.4 billion. For two years thereafter, it only offered shorter term loans at commercial rates. It began offering long-term housing loans again in 1995, at a very preferential rate (11.5 percent) compared to commercial loans. After a slow start in 1995, almost 10,000 loans were made in 1996, averaging US$ 3,400, about the same as in 1992. The rate went up to 12.5 percent in 1997. Demand declined to only 1,200, but the average size jumped to US$ 10,000 (most demand for moderate-size loans for housing construction was met by low-rate loans from the State Housing Fund and building societies). This pace was maintained in early 1998, but slowed after the mortgage rate was increased to 15.5 percent in June 1998, in line with a general interest rate increase.

In 1999, mortgage rates have declined somewhat, to 13.50 percent. However, this is significantly less than the return on government debt issuances, which are running around 16 percent. As noted below, this is presumably because of non-market pricing associated with government control of SLSP.

As in the Czech Republic and Hungary, reducing the dominance of the retail deposit market by the former state savings bank became part of the motivation for creating the building society system and the mortgage banking option for raising funds. This goal may have been somewhat negated by the fact that the only two building societies are controlled by the two major banks (SLSP and VUB, with the building society sponsored by SLSP having 85 percent of the market) and that the only mortgage bank is operating as part of VUB.

INSTITUTIONS: BUILDING SOCIETIES

As noted above, Slovakia was the first CE country to start up a system of building societies. The needed legislation was passed in May 1992 and the Prva Stavebna Sporitelna (PSS), First Construction Saving Bank, started business in November 1992. It was a partnership between SLSP; the largest German building society, Schwabisch Halle; and a large Austrian building society, Raiffeisen.[90] 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 rationale for a building system is discussed at length in the section on the Czech Republic. In summary, the system is designed to collect savings deposits at a low, below-market rate and recycle the low rate on their funding into low rates on their loans. In order to convince people to participate, the government must provide a significant subsidy. The extra payments go towards making the return on savings equal to or even better than the return on 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 cycle.

The Slovak Building Society system can be summarized as follows:

Main Act:	May 1992, first operations in November 1992
Regulation:	Ministry of Construction regulation/supervision of premium payment; Central Bank regulation/ supervision of the building societies, under conventional bank regulations with no additional regulation imposed on liquidity management.
Yearly Premium Amount:	From 1992-1997, 40 percent of savings up to Sk. 6,000. Annual optimal savings Sk. 15,000, about

[90] Some indication of the momentum towards creating a building society 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.

	twice the average monthly wage. In April 1997, the premium rate reduced to 30 percent raising the optimal annual savings amount to Sk. 20,000, about twice the average monthly earnings in 1998.
Minimum Saving Period:	Six years to get housing contractual loan (usually at 6 percent) if 50 percent of contracted sum is saved. Interim loan possible at a higher rate after two years. Originally possible to cash savings and keep premium even after 1 year. Then changed to minimum of 6 years but not necessarily for housing.
Housing Purpose Required?:	As of 1997, housing purpose required to cash the premium even after six years. Reversed in 1998. Housing purposes to be demonstrated by invoices (initial provisions allowed for taking a loan for non-housing purposes).

Other relevant aspects of the system:

(1) Interest and premium on savings exempt from taxation,
(2) Premiums 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),
(3) Interest paid on the loans not tax -deductible, but neither is interest on loans by regular banks,
(4) No penalty for irregular savings patterns,
(5) Only 3 percent offered on savings, under all conditions,
(6) Possible to tie accounts to issuance of a market-rate housing loan immediately (by the parent commercial bank), repayable by the savings and loans proceeds after two years;
(7) Parameters of the state premium not embedded in law and can be set for new contracts by the government annually as part of the budget legislation **(important)**.

The building society system grew quickly in Slovakia. This was partly because, in its original format, it offered the peculiar opportunity to cash out an account after one year and still keep the premium; this created strong incentives to do that each year, rather than save for several years. (It is not known why and how this provision was enacted). Even without these extraordinary returns, the tax-free 40 percent premium promised a higher after-tax return on building society savings than on unsubsidized market opportunities.

Table 5-2 gives the cumulative results of the system.

TABLE 5-2
ACTIVITIES OF BUILDING SOCIETIES IN SLOVAKIA

	1993	1994	1995	1996	1997	1998	1999 (est.)
New Contracts (000)	174	217	272	338	157	182	168
Contracts Outstanding (000)	228	432	644	923	907	920	900
Net Savings (Bil. Sk.)	?	?	12.9	21.1	32.6	40.0	??
Net Loans (Bil. Sk.)[a]	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	??

Note:
a This includes only loans to regular clients. In 1997, there were also about Sk. 200 million in loans to companies for construction.

As in the Czech Republic, the building societies have been very successful in attracting savings. Their success has been due to extensive marketing and the attractiveness of the financial return on savings, independent of the value of the housing loan. Over the minimum six-year savings period, the 40 percent premium on the annual contribution, on top of a 3 percent return on accrued savings, was yielding an after-tax return of about 13-14 percent. Even at the lower 30 percent bonus applicable after 1997, the return is over 11 percent. These returns have been higher than most alternatives, such as bank deposits (about 12 percent less a 15 percent withholding tax). However, the advantage over the market rate has lessened and the growth of the system has fallen sharply since 1997

From the end of 1993 and through April 1997, the maximum subsidy was achieved by saving at a rate of Sk. 15,000 a year for six years. With interest and premium, this provided total savings of about Sk. 130,000. Matched with a loan of the same size and with a second savings amount and loan for a spouse, a couple could acquire a total of over Sk. 500,000 towards a housing investment. As of 1998, this was a relatively large amount, about US$ 15,000—more than 50 percent of the cost of a modest existing flat, a quarter to a third of the cost of a more substantial flat, new flat, or family house.

One reason observers give for the low rate of loan use is that a large portion of savers are happy to receive the higher after-tax return on their savings and not take out a loan (note that the after-tax rate on savings deposits is not much higher than the 6 percent due on a building society loan). Another reason for a low rate of loan use is a quirk of the Slovakian law that permitted early withdrawal of the premium. 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, 19 percent of all savings and

premiums ever accrued. This prevented the maturation of most of the early contracts into regular loans.

A particularly interesting aspect of the Slovak building society system has been its political dynamics. In both the Czech Republic and Slovakia, there has been much comment about how little impact the building society systems have had so far on actual housing investment. However, the two countries differ significantly in how the political system has responded to this concern. In Slovakia, the government itself has control of the annual premium level. As discussed below, the result has been a move by the building societies to make as many housing loans as possible and a move by the government to squeeze some of the subsidy back out of the system to subsidize housing in other ways.

INSTITUTIONS: MORTGAGE BANKS

While Slovakia led in the area of building society legislation, it has followed the Czech Republic with respect to mortgage banks (MBs). Initially, the MB system was to be modeled after the German one, with the banks funded exclusively from bonds and generally separate from the universal banks. This version was passed in 1996, but proved to be uneconomical. In early 1998, the legislation was modified to follow the Czech Republic's approach of allowing universal banks to obtain licenses for mortgage banking activity and fund loans out of deposits, as long as they keep separate legal and accounting records on the activity and are funding loans "primarily" from mortgage bonds. The "mortgages" that provide the collateral for the mortgage bonds do not have to be physically segregated from the other assets of the bank. But they are legally segregated in case of default or bankruptcy, so that they serve exclusively as first-rank collateral for the bonds.[91] This avoids the segmented institutional structure of the classic mortgage bank model.

The significant difference between the two countries in MB development is that Slovakia did not initially endow mortgage banking with as many special subsidies as provided in the Czech Republic. The mortgage bonds are tax-exempt and this is worth a 1.5-2.5 percent advantage over the return on government bonds, which are subject to a 15 percent withholding tax. (Mortgage bonds in the Czech Republic benefit from exemption from a 25-35 percent withholding tax on government bonds.) But there was no direct subsidy to reduce the interest rate further until 1998 and no tax deductibility of mortgage interest.

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[91] It should be noted that, as in the Czech Republic, the Slovak usage is to apply the term "mortgage" only to such secured housing loans that also qualify to back mortgage bonds. This is at variance with usage in most of the rest of the world and is not observed in this report.

Mortgage banking has had no impact so far in Slovakia. Only three banks have obtained a mortgage banking license; one (VUB) started operations in late 1997 and has not issued any bonds. The dominant retail bank, SLSP, started mortgage banking operations in 1998, but really only as a continuation of the housing lending it has done since 1995. SLSP has sufficient and cheaper deposit-based funding and has no need to issue mortgage bonds, but it wanted to be positioned to offer its clients access to any special benefits offered "mortgages" (i.e., qualifying housing loans issued by a bank with a mortgage banking license).

These benefits were forthcoming in late 1998, when a new subsidy of 6 percent was introduced for all "mortgage loans" (i.e., issued by a mortgage bank). However, mortgage rates at 13.5 percent remain below the likely rate on any issuance of mortgage bonds (about 14 percent) and thus the "mortgage bank" structure remains effectively non-operational.

MORTGAGE DESIGN

Currently, the great majority of mortgages continue to be made by SLSP based on a standard adjustable rate design, usually for 15 years. The rate as of June 1999 was only 13.25 percent, down from 15.5 percent in 1998 but up from the 12.5 percent applicable since 1996.[92] VUB is promising to limit increases beyond the first five-year period to 5 percent, thereby providing some protection to borrowers but exposing VUB to some interest rate risk. VUB will also consider extending the term to 30 years. SLSP has started offering fixed rate loans at 13.5 percent for five years, since the mortgage banking law requires that the term on the loan rate match the term on the bond.

At this point, both SLSP and VUB are funding these loans primarily out of their medium-term deposits, with VUB also drawing funds from the VUB Wustenrot building society. However, VUB hopes to issue a mortgage bond when their accumulated volume is large enough to support one. It is questionable, though, whether the rate on the bond will be competitive with the cost of bank deposits.

In Slovakia, the mortgage banking law allows LTV ratios only up to 60 percent, not 70 percent as in the Czech Republic. However, VUB does offer additional loans beyond the "mortgageable" amount. As in the Czech Republic, the payment-to-net income (PTI) ratio is usually about 30-35 percent.

A recent feature on the Slovak housing finance market is the offering of "instant loans" by the building societies. Apparently, they will immediately provide a loan at 6-7 percent (little different from their conventional 6 percent rate), if the saver deposits the

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[92] An indication that these rates are being cross-subsidized to the advantage of the public (and to garner political support) is that the rates on one-year government bonds are running 16 percent.

full savings portion of a contract with the building society. In effect, the building society lends the borrower funds at 7 percent. But since half the funds comes from the saver's own funds, the effective cost of the additional funds is 14 percent, similar to the rate at a regular bank. However, as the loan is repaid, the principal payments are counted as "savings" under the building society law, thus earning the 30 percent premium. The net effect is that the cost of funds under this scheme for an immediate loan is lower than for loans from the regular bank.

SUBSIDIES

Just as in the other countries, Slovakia has provided deep subsidies for new housing, as well as for the building society system. Until recently, it avoided linking those subsidies to taking out a conventional mortgage. In fact, the government undermined the conventional loan market by offering its own loans at a very low rate. The net effect is that the market for unsubsidized private finance has steadily shrunk.

Some aspects of these subsidies have been discussed above. This section examines them more systematically.

New Municipal Rental Housing

One major short-term source of additional subsidy for housing has been a major effort to finish construction of additional municipal rental flats left incomplete in 1989. This has involved the "contribution" of Sk. 2 billion from the resources of the National Privatization Fund, sufficient to finish 1,500-2,000 additional panel flats. Presumably these units will be rented at the normal regulated rent for municipal flats, which does not cover even full operating costs. How the local governments will cover this additional deficit is not clear. But with the central government picking up the cost of construction, the operating subsidy is a relatively small price to pay.

This completion of unfinished municipal flats is a one-time effort. Discussion about starting up some kind of non-profit social housing sector has been extensive, but no definite plans exist at this point. At a minimum, such plans await the deregulation of rents on new housing.

Building Societies

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

This has been a source of controversy. Through 1997, the building societies had made relatively few loans for housing (other than bridge loans or "instant loans") and appear to have had little effect on housing activity, compared with, say, spending the same amount on direct construction or lump-sum subsidies.[93] In some ways, this is not surprising, since the basic contract with the building society calls for completion of a six-year savings program. With many contracts started only in 1993, now significant number of loan completions can be expected before 1999.

However, the building societies offer "bridge" loans after only two years of saving. These essentially allow for borrowing now and payback through completion of the normal building society savings and borrowing cycle. Relatively few took out these loans. This may have been because the effective interest rate while awaiting completion of the savings contract had been the market rate, about 12-13 percent, until 1997 and few were interested in borrowing at the market rate. In 1997, under political pressure to show results, the building societies cut this rate in an effort to encourage additional borrowing, even at effective rates to them that were much less than available on government bonds, the major investment alternative. To further encourage borrowing, they also made contracts assignable to any "first-rank" family members.

As noted, the building societies have gone even further, introducing what are called "instant loans." These do not require any prior regular savings, but do require deposit amounts equal to half the loan amount with the building society. In 1997, in order to encourage more lending, the building societies reduced the effective rate on these "instant loans" to 10 percent, which is significantly below-market.

The continuing weak demand for loans from the building societies can be attributed to at least three factors. First, the initial premium rate of 40 percent created such a high rate of return that the building societies 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 three to four years old. Third, as described below, since 1996 the government has provided loans on new housing at only 1 percent, with no prior savings requirement.

The controversy over the efficacy of the building society system to resurrect housing production is all the more relevant because the government can unilaterally alter the total premium amount available for new savers in each year's budget. Thus, the bonus and other parameters of the system can be changed without action by the

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[93] This has also meant that the building societies are able to make extraordinary profits. For example, in 1997, the dominant building society, 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.

Parliament. This tends to neutralize the building society lobbying efforts. Instead, they must negotiate directly with the government.

One result of these negotiations has been an *ex post* extrication of subsidies through successful government "persuasion" of the building societies to purchase State Housing Fund bonds at a below-market rate. Over Sk. 1 billion in such bonds have been bought by the building societies, 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, which are unconnected with any prior savings but allow the building societies to claim they are supporting housing construction.

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

In addition to these efforts to channel more of the past building society subsidies into housing, the government has taken some actions to tie their contracts more closely to housing and also reduce the extent of future subsidies for simple saving that is not tied to housing investment. For contracts started after 1 January 1997, withdrawals, even after the six-year savings period, did not get the state premium unless invested in housing. 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 about equal to currently elevated interest levels in the country. These actions significantly slowed the growth in building society accounts (and the burden on the state budget) and were reversed in 1998.

State Housing Fund

In 1996, because of the continuing lag in housing activity despite four years of large building society contributions, the government decided to create a direct subsidy scheme through a State Housing Fund (SHF). Many schemes were considered in an extensive analysis of how the state could best intervene directly into the housing market. The eventual outcome was a simple low-rate loan scheme, originally mostly to private individuals for privately owned newly constructed housing.

The typical arrangement includes a grant 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, with the interest rate 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. Nearly all applicants so far have qualified for the 1 percent rate.) Such an amount is about half the cost of a modest new flat (60 sm., at Sk. 20-25,000 per sm.), and 25-30 percent of the cost of a new family house or larger flat.

This deep subsidy has finally stimulated 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. Yet another 7,000 were approved in 1998. (Only another 2,700 approvals are expected in 1999 because of tight budget conditions.)

This impact is not surprising, since the SHF goes back to the sort of deeply subsidized long-term loan the public had experienced before 1989 and 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, are 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 hard to pass up.

In the first year of the program, only Sk. 800 million was actually disbursed. Disbursements jumped to Sk. 1.7 billion in 1997 and another Sk. 3.5 is expected in 1998. Only about Sk. 1 billion of the funding for the SHF has actually come from the government budget. The rest has come from below-market bonds sold by the fund to the building societies and contributions from the National Privatization Fund. It is unclear that this rate of funding is sustainable.

There are also plans to try to target the SHF by house size and price. Currently, it is offered on a first-come basis (and already has a substantial backlog) for all new home purchases, no matter what size or cost. (One effect has been a noticeable increase in the quality of finishing, often to luxury levels, as a portion of the extra funding flows into quality upgrading instead of additional units.) There are also plans to devote some of the funding for social rental housing developed by non-profit entities (but this depends on ending the current rental price controls, which apply even to new units).

The government has contracted with the third largest commercial bank, the IRB, to administer the SHF. This should help reduce the role of political favoritism in allocating the funds, but it remains to be seen if borrowers will take advantage of the government guarantee on their loans by withholding repayments. On the one hand, it is unlikely that the IRB and the SHF would pursue remedies to default as vigorously as a bank making loans out of its own funds; on the other hand, at such a preferential interest rate and overall deep subsidy, there is little reason for a borrower to have trouble repaying or to take the chance that they might lose their house.

Mortgage Banking

Mortgage banking now receives two major subsidies, the ability to issue bonds that are exempt from the 15 percent withholding tax and, new in 1999, access to a 6 percent reduction in the rate for all "mortgage" loans (housing loans made by a mortgage bank). This does not provide enough subsidy to make bond issuance attractive as a mode of financing housing any time soon, relative to deposits. However, the interest rate subsidy may start costing significant funds, once the net cost of mortgage loans drops below that on Bauspar loans.

The 1999 additional subsidy to mortgage loans was the result of strong lobbying to replicate some, if not all, of the subsidies available in the Czech Republic. In fact, it substantially exceeds those subsidies both in size and coverage (the Czech subsidy only covers loans for new housing). Relatively little attention was paid, though, to how small an effect these subsidies have had on borrowing in the Czech Republic.

Combining Subsidies

As in the other CE countries, households appear very adverse to borrowing at full market rates. However, once finance is subsidized deeply enough to avoid becoming burdensome (or to cost less than the returns available from bank deposits), households will borrow and more will build or buy houses.

In Slovakia, this threshold was not crossed until the State Housing Fund started up its activities in 1996. Prior to that time, most housing subsidies were in the form of premiums to building society accounts, which (for accounts opened prior to 1997) could be taken out without spending the proceeds on housing, much less actually taking a loan for housing. The building societies have had only a little success in convincing households to take out bridge or instant loans, even when effective rates are less than market rates.

As long as the SHF continues to be well funded, the total package of subsidies should remain quite attractive and effective. A young couple (and 90 percent of the SHF borrowers are under 30 years old) with typical white-collar jobs is likely to have a household net income of about Sk. 15,000 a month. If they obtain a SHF grant for Sk. 150,000 and a 1 percent loan for Sk. 500,000 for 30 years, their monthly payment would only be Sk. 1,600. If each already has an average size building society account involving contributions of Sk. 1,000 a month, together they are bearing a total monthly payment of Sk. 3,600 a month or almost 25 percent of their monthly income.

This couple could ask the building society for a bridge loan of about Sk. 300-400,000, based on the prospect of being able to repay the bridge loan fully with the amounts derived when their contracts (savings and the 6-percent loan amount) come due in 2-3 years. This gives them about Sk. 1.0 million in funding for a modest new

unit, which is nearly enough in towns other than Bratislava and is two-thirds the cost of a unit in Bratislava. The market response (a rapid rise in average expenditure per square meter) seems to indicate that these households have sufficient other funds to add to this amount to upgrade the size and quality of their new unit.

In any case, the threshold for people to take action on building new housing now seems to have been crossed and new housing starts have surged. If both a maximum SHF loan and two optimal building society loans are involved, the present value of the total subsidy would be about Sk. 500-600,000 or about 33-50 percent of the cost of a new flat. This is similar to, or even a little higher than, the range of subsidy being provided buyers of new private housing in the Czech Republic. However, in the Czech Republic even larger subsidies are available for those lucky enough to get an addition to the municipal rental stock.

Table 5-3 confirms that Slovakia is devoting significant efforts to subsidize housing, particularly new construction. The 3.4 percent of the state budget involved is greater than the on-budget amounts in any of the other CE countries.

TABLE 5-3
SUBSIDIES TO THE CURRENT MARKET FOR HOUSING FINANCE IN SLOVAKIA, 1998

Program	Budgeted Amount (Sk. Millions)	Number of Units	Amount per Unit (Sk.)	Targeting
Building Societies	3,200	900,000 contracts	3,555/contract	All Housing Related
State Housing Fund	3,500[a]	5,400	650,000	New Housing
Total	6,700 (3.4 % of Budget)			

Note:
a 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 building societies.

There are no data on transactions in existing housing. Such units are available at a price of less than Sk. 1 million, but do not qualify for SHF funding. They do qualify for the subsidized loans provided by building societies and presumably some loans are being used for that purpose. In addition, SLSP and VUB will make loans for such purchases, at market rates. However, since the SHF and the building societies have moved strongly into the market, lending by the commercial banks has shrunk to 1,000-1,500 loans a year, averaging about Sk. 300-400,000 each.

OTHER FACTORS AFFECTING THE HOUSING FINANCE MARKET

In addition to the past and recent history of housing policy, the institutional structure of the housing finance sector, and the subsidies that shape the market for mortgage finance, a number of other factors affect either the demand for finance or the supply (i.e., the willingness of lenders to make loans).

Demand Factors

Slovakia has had, until recently, relatively low real and nominal borrowing rates for home mortgages. Inflation had been running at only 5-6 percent until it increased to over 7 percent in 1998. The SLSP had been offering housing loans for as little as 11.5 percent until 1997, when rates went up to 12.5 percent, still only 6-7 percent over inflation. These rates were well under the interbank market rates of 16-25 percent applicable during most of this period, reflecting the political sensitivity of the housing sector and the government control of SLSP. The mortgage rate went to 15.5 percent in June 1998, even though the government was paying over 28 percent for short-term funds. In 1999, the two-year government bond rate has fallen only to 16 percent, but mortgage rates are now 13.5 percent.

At these rates, loan affordability is quite high even without any form of indexation. The real cost of borrowing is substantially lower than in Hungary and Poland. In addition, Slovakian households can borrow almost twice as much as a Hungarian household with a similar income.

As indicated in Table 5-4, these conditions did lead to a surge in demand for conventional loans (albeit at below-market rates) in 1996. Many of these loans were for renovations, as evidenced by the average loan size of about US$ 3,400. However, this budding market in renovation loans appears to have been clipped by the first wave of building society loans in 1997. The number of conventional loans fell by 87 percent in that year, although the average size rose to US$ 10,000.[94] Both lending and loan size has trailed off since then.

As in the other CE countries, most households appear reluctant to borrow at positive real interest rates. On the assumption that all the 1241 loans in 1997 were for purchase of a house, and that half were for the purchase of a new house, for example, about 5 percent of the 13,000 housing starts in 1997 benefited from a conventional loan. Even if 7,000 of these starts were financed by SHF loans, that should have left a potential demand for loans on 5,000 houses. In contrast, the actual demand for loans was only 620 (assumed half of 1241).

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[94] Demand for market-rate mortgage credits also has been undermined by the combination of 1 percent funds from the SHF. If and when the funding to the SHF is reduced, it is likely that the overhang of eligibility for low-rate loans from the building societies will keep demand for market-rate loans low.

TABLE 5-4
MORTGAGE LENDING BY SLOVENSKA SPORITELNA

YEAR	Number of Loans	Total Volume (Sk. Mil.)	Average Size (US$)
1995	1728	365.6	6,800
1996	9949	1,059.7	3,400
1997	1241	406.1	10,000
1998	936	290.6	9,100
To 6-99	348	100.5	7,800

Supply Factors

Whatever reluctance the banking sector may have had about mortgage lending appears to have been overridden by political considerations. However, most observers have expressed the view that the laws supporting loan recovery are still not as strong as they should be. Ironically, the situation is coming to a head now that the privately held building societies are making loans of a significant size and will soon become the largest housing lenders in Slovakia. (The building societies require an actual mortgage only in cases of loans over Sk. 200,000.)

Banks also have new reasons to focus on these concerns, because they will rely on residential mortgages being strong collateral for the mortgage bonds they hope to issue. Even the Ministry of Construction, which runs the State Housing Fund, is accumulating a large portfolio that may require some enforcement activities.

Concerns about loan recovery center on several issues:

1. The Civil Code requirement of alternative accommodation in case of eviction.

2. The Commercial Code guidelines for foreclosure and auctioning of property.

3. The laws governing the Land Register, which permit different ownership for land than for the improvements located on it. This makes a mortgage on improvements alone impossible to enforce.

4. The low priority of mortgage liens relative to wage and tax liens. Moreover, the Banking Act only allows "first-rank" mortgages to serve as mortgage bond collateral. This somehow seems to prevent privatized flats from qualifying, since legislation provides a right of lien by the other owners in the building.

5. Absence of the data needed to support accurate appraisals. In this respect, it would help if privacy laws could be modified sufficiently to support a credit bureau approach to underwriting.

Progress is being made on the first two of these issues. In 1997, the Civil Code was amended to include relatively minimal "shelter", even in another location, to qualify as alternative accommodation (the same solution provided for in the Czech Republic in 1994). Apparently, a notarial procedure granting permission to take over property through non-judicial procedures has also been enacted. Meanwhile, a proposal to clarify and strengthen the auction process has been made and is expected to be considered by the new Parliament.

All these aspects of loan recovery are being pursued by a working group of the relevant parties convened under the auspices of the Ministry of Finance.

Slovakia is faced with another long-term problem on the supply side of its housing finance market. The former state savings bank still has 50 percent of the deposit market, is government-owned, and is under political pressure to make housing loans at below-market rates, thus precluding meaningful entry of other lenders. Moreover, the SLSP's building society has 85 percent of the building society market. This dominance of the housing finance sector by one institution, no matter well-intentioned, will tend to stifle the market-expanding benefits of competition. However, the new government is moving as quickly as possible to privatize SLSP.

CHAPTER 6

RUSSIA[95]

Population: 146.3 million (1998)
GDP: Rbl. 2.7 trillion (1998)
State budget: Rbl. 657 billion (1998)
Exchange rate: Rbl. 6.0/USD 1.0 (December 1997); 20.6/USD 1.0 (December 1998)

BACKGROUND

Housing Finance Under Communism

Until 1991, Russia, as part of the Soviet Union, had one of the most regulated housing markets in the world. Housing construction and allocation was under total state control. The only activity that could be called market-oriented was informal and hidden.

Because the emphasis was on state-owned rental flats managed either by state enterprises and organizations and allocated mainly to their employees, or by local Soviets (municipalities), nearly 80 percent of the stock in cities and towns belonged to the state. However, it was still possible (generally in rural areas) to obtain land for construction of single-family houses as long as that construction was in compliance with strictly regulated norms and rules. Housing construction cooperatives constituted only a small share of the overall housing stock.

As of 1990, the overall housing stock of 2,425 million square meters was distributed in the following manner:

Housing Unit Status in 1990:	
Public Rental:	
Local Soviets (municipalities)	25 %
State organizations and enterprises	42 %
Other rental (mostly of farming cooperatives)	3 %
Owner-occupied:	
Single-family houses	26 %
Co-operatives	4 %

All state rents were strictly controlled since they had not been changed since 1928, rents for state housing in 1990 constituted only about 1 percent of family

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[95] This chapter was prepared by Nadezhda Kosareva using information from *Restructuring Russia's Housing Sector: 1991-1997,* edited by R. Struyk, The Urban Institute, Washington, DC, 1997. It was edited by Douglas Diamond.

income—and represented only 20 percent of housing maintenance costs. The remaining 80 percent came from state funds: 60 percent from the state budget and assets of state enterprises and 20 percent from the income of housing and maintenance organizations from rents for commercial space. Communal services (utilities) were also subsidized at 80 to 90 percent. When utilities are included, total housing cost to tenants amounted to about 2 percent of family income.[96]

New housing was also predominantly financed out of centralized resources of the state budget and state enterprises (88 percent). Loans originated by the state savings bank (*Sberbank*) for construction and renovation of family houses or housing cooperatives were strictly limited and regulated, and negligible in amount. In 1991, outstanding loans to individuals covered about 0.2 percent of units in the 1990 housing stock, 0.8 percent of the 1990 single-family housing stock, and only about 0.3 percent of GDP. Only 7 percent of all investment in housing was covered by housing loans.[97]

The volume of residential lending was established in the annual national economic plans. Housing loans could not be secured through mortgages, as it was impossible to evict a defaulter from the mortgaged housing. The only type of security typically used by lenders was an employer deduction of loan service payments from employee pay.

The key lending instrument was a fixed interest rate loan that was partially cross-subsidized: the 2 percent loan interest rate used in 1991 was below the banking interest rate on one-year deposits (3 percent) and only 1 percent higher than the official rate of inflation. Loan terms were 25-30 years. Loans for co-op construction of residential units were even more highly subsidized with interest rates on loans at a mere 0.5 percent. LTV ratios were in the range of 70-75 percent. These high levels were because the absolute limit on borrowed money based on the construction cost of a housing unit matching the “social norm” for a given family size.

Initial Adjustments[98]

Several important adjustments were made in the housing and housing finance sectors between 1990 and 1995. New legislation was enacted to transfer most state-owned stock to municipal governments and state and municipal stock to sitting tenants.

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[96] “Implementing Housing Allowances in Russia. Rationalizing the Rental Sector”, Raymond J. Struyk, Nadezhda Kosareva, Jennifer Daniell, Charles Hanson, Maris Mikelsons; The Urban Institute Press, Washington, DC

[97] “Russia: Fast Starter – Housing Sector Reform in 1991 – 1995” by R. Struyk in R. Struyk, ed., *Economic Restructuring of the Former Soviet Block. The case of housing.*, The Urban Institute Press, Washington DC, 1996

[98] This section benefited from an article “Emerging Long-term Housing Finance in Russia” by Nadezhda B. Kosareva and Raymond J. Struyk in *Housing Finance International*, March 1996

Privatization began with very low prices but shifted to a free-of-charge process. By the end of 1995, the tenure pattern had changed dramatically in urban areas:

Housing Unit Status in 1995:

Public Rental	
Local Soviets (municipalities)	30 %
State organizations and enterprises	10 %
Other rental (now mostly dormitories of joint-stock companies):	7 %
Owner-occupied:	
Single-family houses and owned flats	44 %
Co-operatives	4 %

The tenure change was even more marked in urban areas than overall.

From 1992 through 1995, only 41 percent of all eligible state and municipal housing stock was privatized, despite free-of-charge privatization. This is primarily because rents were not raised at all until 1994 and are still quite low. In addition, tenants have tenure rights nearly equivalent to that of an owner (but at a lower maintenance cost). Moreover, since tenants could use the right of free-of-charge privatization only once, those in units that were in bad condition, poorly located, or small had an incentive to wait for a better rental unit before exercising that right.

As shown in Table 6-1, new construction activity fell sharply after 1990 and is continuing to fall. The main reasons for this decline are cutback in governmental financial support of the housing sector, low private effective demand for housing, and lack of proper mechanisms to finance construction and purchase of residential property through loans.

TABLE 6-1
COMPLETIONS OF HOUSING UNITS IN RUSSIA: 1985-1998

YEAR	# Of Units Completed (000)
1989	1,242
1990	1,044
1991	940
1992	682
1993	682
1994	611
1995	605
1996	482
1997	430
1998	388

The most significant policy changes so far have involved the structure of housing finance resources. The budget's share in funding new housing production dropped from 90 percent to 26 percent after the onset of reforms. Residential construction financed by state enterprises and organizations fell by 50 percent. However, the number of houses built and financed by individual families doubled from 1990 to 1998, reaching almost 40 percent of the total annual volume of housing production.

This growth in individual housing construction is attributable to (a) the lifting of previous restrictions, which limited the number and size of privately owned residential units and prohibited construction of individual family houses in cities with more than 100,000 population, and to (b) the land reform. These reforms simplified the procedures of land allocation for individual housing construction, permitting the privatization and sale of land.

Inflation soared in 1992. The initial government reaction was to attempt to sustain the old system of housing finance. After 1991, when Sberbank became a commercial bank, interest-free loans subsidized from the federal budget became a priority to support new construction. Starting in April 1992, Sberbank offered loans for the construction of individual and cooperative housing with an interest rate of 20 percent. Under an agreement between Sberbank, the Ministry of Finance of Russia and the Central Bank of Russia (April 1992), 12 percentage points of the 20 percent per annum interest rate was covered by the budget. These subsidies were believed necessary to offset the increases in house prices and interest rates associated with inflation. In contrast, a loan to purchase an existing single-family dwelling over 15 years was set at market levels, which could be no less than the Central Bank rate of 80 percent.

Throughout 1993 and until August of 1994, the interest rate for housing purchase was always higher than for construction loans; after that they were equalized. Simultaneously, a new Government resolution limited households purchasing a unit through a housing cooperative that began construction before January 1992 (later changed to January 1994) received grants covering 70 percent of the increase in construction costs and interest rate increases since that date. The cost of these subsidies was shared equally between the Federation and lower levels of government.

The subsidies in both of these programs were poorly targeted, with no income, unit size or other restrictions on eligibility.

By the beginning of 1993, due to the high inflation, the cost of funds to Sberbank increased (the interest rate on one-year deposits was 60 percent) and outstanding loans

based on direct budget subsidies given after 1992 were incurring major losses.[99] Under another agreement between the Sberbank of Russia and the Ministry of Finance of the Russian Federation (April 1993), a new credit policy was launched, giving Sberbank the right to conduct retail lending on market terms. In order to avoid interest rate risk, Sberbank started to grant housing loans at an adjustable interest rate linked to the discount rate of the Central Bank.

The Ministry of Finance, in turn, entered into a commitment to subsidize the interest rate on outstanding favorable and interest-free loans up to the level of the Central Bank discount rate. These were supposed to be extended to highly targeted groups, including Interior Ministry officers, forced migrants, refugees, victims of Chernobyl calamity, etc. Thirty groups in all were these housing loans. With interest rates being extremely high, these liabilities became a further burden on the budget. It became virtually impossible to grant new loans on these terms, and Sberbank of Russia and the Ministry of Finance made a joint decision to terminate further lending in August 1995.

Macroeconomic Evolution

The liberalization and restructuring of the Russian economy started in 1992 when the centralized and planned economy collapsed. The most cardinal changes in the Russian economy were already under way in 1992-1993. These included the price liberalization of 1992 which produced a 2500 percent inflation that year, followed by another 850 percent in 1993, and the onset of mass privatization in various sectors, including housing, and emergence and dynamic growth of private companies and commercial banks.

The reform process in Russia turned out to be very painful for the majority of enterprises and residents. Russia witnessed a 50 percent cut in manufactured output from 1991 to 1999, and a net decline of 40 percent in measured GDP from 1991-1998, accompanied by a dramatic fall in individual real personal incomes.

However, from late 1994 on, the macroeconomic situation in Russia became increasingly stable and several promising economic trends emerged. During this period Russia witnessed formation of the types of credit, financial, and industrial institutions typical for countries with strong market-oriented economies. An interest rate reduction in late 1995 created a favorable environment for the development of long-term lending. The best period was 1997, when inflation was less than 11 percent and real personal incomes grew by 3.4 percent.

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[99] As for loans extended before 1992, they were nearly totally devaluated by the hyperinflation triggered by the price liberalization, which also depreciated individual deposits and made it practically impossible to compensate incurred losses.

The August 1998 financial turmoil resulted in the bankruptcy of a great number of companies, including many commercial banks. The federal government's refusal to repay its internal debt resulted in frozen bank deposits and a moratorium on repayment of bank debt commitments. Simultaneously the government abandoned its policy of keeping the ruble exchange rate in the "currency corridor". The plummeting of the ruble exchange rate that followed demolished the value of ruble savings and incomes and stimulated high inflation (rising from almost nothing to 80 percent in 1998) due to the strong import-dependence of the Russian economy. However, the crisis gave several industries the opportunity to rapidly increase their output and offer their products on the domestic market as import substitutes. In the first six months of 1999, the inflation rate was down to 24 percent, and the ruble/US$ exchange rate stabilized at 24-25 rubles to the dollar.

EVOLUTION OF HOUSING POLICY

Among other things, the onset of the general economic restructuring in Russia stimulated reforms in its housing sector, the priorities of which were formulated in the federal law *On Fundamentals of the Federal Housing Policy* (1992). These reforms had four major components. The first, a gradual increase in rents and utility charges paid by tenants of state and municipal residential units, was launched in 1994. But progress has been slow, with actual cost coverage by tenants reaching only 35 percent so far. Because incomes remain low and government fears the political consequences of increasing the publics housing cost burden, the deadline for reaching the program goal of 100 percent coverage has been repeatedly postponed (initially 1998, then 2003, and now 2008). Simultaneously, an income-tested housing allowance program was launched to moderate the impact of rent reform (with 5.6 percent of households now covered).

The second component of reform was development of a competitive structure in the housing construction and maintenance sectors. The third was creation of a more efficient system of housing finance subsidies and the fourth was promotion of the market-oriented instruments of housing finance. The third and forth tasks housing sector reforms are our focus her.

With reduced federal budget funds available to finance residential property construction, responsibility for addressing the perennial shortage of housing was shifted to municipal budgets. The previous mechanism of free-of-charge allocation of housing became nearly inoperative, with only a quarter as many units allocated in 1997 as in 1990. Federal funding was restricted to a few highly targeted groups including: military servicemen, including retired personnel; citizens resettled from the Far North Region, and those displaced by the Chernobyl catastrophe.

Creating more effective schemes of budgetary housing subsidies and market-based mechanisms of housing finance became an imperative. In 1993, the president adopted the decree *On the Development and Introduction of Non-Budgetary Forms of Investment Into the Housing Sphere*, and the Government passed a program called *Housing* (with one of its components—housing finance—detailed and expanded in a separate program *Your Home* in 1996). These documents set out the main steps, most of which are currently being implemented:

1. Provision of up-front housing subsidies to individuals for construction or purchase of housing,
2. Issuance of housing certificates (bonds) or other securities to finance housing construction,
3. Development of long-term mortgage lending,
4. Creation of a secondary market through formation of the Federal Agency for Mortgage Lending.

Subsidization has shifted from the previous policy of deep subsidies of low-rent housing to targeted up-front housing subsidies to individuals willing to purchase or construct housing. In 1994, municipalities started to use a general scheme designed at the federal level for delivering up-front subsidies to those on the waiting list for housing or those eligible for interest-free loans who have not received them. These subsidies range from 5 percent to 70 percent of the cost of a unit meeting the social norm for the household, with larger subsidies going to families with lower incomes and more years on the waiting list. The objective of the subsidy is to assist moderate income families purchase a unit: the designers recognized that higher income households could fend for themselves.

Similar changes took place in developing mechanisms for providing financing subsidies to targeted groups. While in 1995 only 7 percent of all budget housing appropriations were invested in up-front subsidies (the rest went directly to new construction), by 1997 this share had risen to 15 percent. An even larger shift was caused by implementation of the presidential program *State Housing Certificates* and the Russian Federation Law *On Housing Subsidies for Residents Migrating from the Far North and Similar Regions* in 1998. As a result, the share of up-front subsidies to individuals in the 1999 federal housing budget is 66 percent.

The key principles of these programs are:

- Targeted use of funds: amount of subsidy varies with the circumstances of the beneficiary,
- Transparency of cash flows, clear and simple system of responsibilities,
- Requirement to use individual savings of a beneficiary in addition to the subsidy granted to that individual (co-finance),

— Free choice of housing by beneficiaries (notable for not requiring the purchase of new units).

The distinguishing feature of the programs is that subsidies are paid to retiring, or retired servicemen only for purchase of completed housing (for migrants from the Far North they are also for housing construction). This is a reasonable requirement because it lowers the risk in an inflationary economic environment that buildings either will not be finished on time or will require additional financing.

To complete the task of promoting long-term residential mortgage lending, it was first necessary to develop an adequate legislative framework. (Previous legislation actually deprived the lender of any right to satisfy its mortgage claims or evict the debtor from the mortgaged property in event of a default).

The law *On Pledge* passed in 1992 provided general guidance for pledge transactions. In view of the absence of legislation regulating pledge of real estate (mortgage) and reluctance of the Russian Parliament to issue such legislation (mostly caused by the Parliament's unwillingness to promote private land ownership, including land mortgage), the President signed a series of decrees. The decree *On Housing Loans* (1994) laid out procedures for originating mortgage loans for purchase of housing units and land plots or construction of housing. The presidential decree of 1996 formulated once more the provisions of the draft law *On Mortgage*, then pending enactment by the State Duma (the lower house of the parliament). However, the court in its practice refused to recognize the decrees as legitimate.

In 1995-1996 the Civil Code of the Russian Federation was enacted. The Code established general rules of using real estate (including residential real property), to secure loans, and formulated grounds for foreclosing a mortgaged residential property. But it failed to make the procedures of defaulter eviction more expedient.

In 1997, the badly needed law *On State Registration of Real Estate Rights and Transactions* was passed. Finally in 1998 the law *On Mortgage (Pledge of Real Estate)* was approved, which provided clear guidance on how to solve the foreclosure and eviction problem. According to this law, the borrower and household can be evicted from the mortgaged property if the borrower gave written consent, before moving into the purchased unit, to vacate it in event of default. (The law left unsettled the problem of eviction when minor children are present.)

In addition to high credit risks caused by the lack of well-defined provisions of mortgaged property in favor of the bank in case of loan default, the development of residential mortgage lending was impeded by:

- High and volatile inflation rates, implying great interest rate risk for long-term lending, since the banking system's liabilities were heavily concentrated in short term accounts,
- Extremely low housing affordability,
- Lack of the relevant expertise and skills in providing such services on long-term mortgage lending to clients,
- High rates of return on alternative hard currency operations and later, since 1994, on operations with treasury bills (GKOs).

Despite problems in making long-term loans for unit purchase, substantial progress has been made in initiating mortgage lending. Banks became rather innovative in the creation of various "quasi mortgage" schemes, which made it possible to lower credit risks in case of legislative ambiguity. According to experts' estimates (official statistics are unavailable), in 1997 the volume of extended loans totaled US$ 100 million.

The financial turmoil of August 1998 brought major Russian banks already involved in residential mortgage lending to the verge of bankruptcy, but at the same time increased the interest in lending on the part of some banks, because of the growing lack of other reliable and profitable investment instruments.

Now that the law *On Mortgage* has been enacted, the banking community is faced with only one serious problem—lack of long-term resources. With this problem in mind the federal government designed and approved the program *Your Home* (1996) which among other things, called for an Agency for Housing Mortgage Lending designated to create the secondary mortgage market in Russia. The agency was founded in 1997 with the technical assistance of the USAID (via the Urban Institute and the US secondary market company, Fannie Mae).

As of mid-1999, the Russian Federation Government and the Central Bank of Russia are drafting general conceptual considerations for long-term mortgage lending. Two traditional schemes of mortgage finance are under scrutiny: the "American" system, according to which the basic resources are attracted through special institutions operating on the secondary mortgage market, and the "German" system, under which resources are attracted through mortgage banks placed under special regulation. A reasonable combination of the two seems a likely outcome.

The German and Austrian Bauspar System, which has been adopted by a number of Central European countries, was examined by the Sberbank of Russia but rejected because it required substantial budgetary subsidies. The volatility of inflation

and interest rates lowers the capacity to predict both availability of budget resources and program demand. Up-front subsidies allow the subsidizing process to be better defined and targeted specific groups.

Along with creating conditions favorable for the promotion of long-term mortgage finance, the government has sought to widen the provision of housing finance beyond credit and banking institutions. The prime motivation of this effort was to promote production and sale of new housing. Among other initiatives, developers have been attracting funds of prospective housing purchasers at the construction stage (using share participation or investment contracts), or selling the completed housing by installments, as when a purchaser pays for the unit over a set period of time and acquires ownership only upon full payment.

To assist in these developer efforts, the government authorized the issuance of special bonds (housing certificates), with nominal value denominated in square meters. Through these certificates, a client purchases a certain amount of floor space of a residential unit, thus providing funds for housing construction. Upon accumulation of a required amount of square meters (certificates) and building completion, the client becomes the unit-owner. Such bonds have certain weaknesses, however. They are not income-bearing securities, they fail to offer the clients the option to choose an apartment, and as a rule investors can purchase units only in specific buildings, perhaps not meeting their requirements. Thus, these housing bonds are designed primarily to finance municipal support for the residential construction sector, rather than to stimulate the growth of effective housing demand.

These special housing bonds were issued mostly by regional and local authorities. In 1994, the total amount issued was about US$ 250 million (Rbls. 500 billion). They were particularly popular during the period of negative interest rates on bank deposits (1994 - 1995). Issuance is now shrinking.

INSTITUTIONS: UNIVERSAL BANKS

Russia started financial reform with four dominant state banks—*Sberbank* (Savings bank), *Promstrojbank* (Industrial and Construction bank), *Zhilsotsbank* (Bank for Housing and Social Development), and *Vneshtorgbank* (Foreign Trade bank). In the pre-reform era, the first three had been responsible for residential construction finance, either channeling centralized capital investments in state housing construction (mostly through Promstrojbank), or providing loans to housing and construction cooperatives (Sberbank and Zhilsotsbank).

With the onset of banking sector reform, both Zhilsotsbank and Promstrojbank underwent substantial re-organization and were split into several commercial banks. As a result, Russia developed the usual two-level banking system: the Central Bank of the

Russian Federation on one level and commercial universal banks on the other. The country initially witnessed formation of a great variety of commercial banks (with 3,000 licenses issued by the Central Bank). Even by mid-1999, almost 1,600 remain in operation. These are universal banks typically with general licenses to perform any banking operations specified by the legislation and bank's charter (excluding currency operations, which several banks are not permitted to perform). Whether or not to create specialized banks still remains under discussion.

Sberbank is still the largest Russian bank, dominating on the retail banking market, capturing 70-80 percent of individual savings. It has preserved its "pre-reform" structure and its net of regional affiliates (within the boundaries of the Russian Federation). Although the state controls more than 55 percent of Sberbank's authorized capital via the Central Bank, the bank acts as a commercial institution fully independent in its lending and housing finance policy. In 1993, it turned to originating commercial loans to housing and construction cooperatives and individual clients. However, when the Ministry of Finance terminated its agreement with Sberbank to cover the interest rate difference on interest-free loans provided to targeted groups in 1995, the bank revoked this lending program.

All of Sberbank's regional affiliates are allowed to issue ruble-denominated housing loans, which must be secured by guarantees of four natural persons (instead of mortgages on purchased property). In August 1999, the interest rate on such loans was 42 percent. So far, Sberbank has treated this form of loan security as more reliable than residential property mortgages. But in fact, the record of such loans is very small—mostly due to the high interest rate and extremely cumbersome procedure of making a loan decision, which imposes the requirement to close four guarantee agreements, perform underwriting of the borrower and its guarantors, and collect all relevant documents.

The Moscow affiliate of Sberbank also participates in the Moscow mortgage program, which permits it to issue mortgage loans in US$ for 10 years at 12 percent per annum. This interest rate is dictated by program participation requirements, according to which the Moscow mortgage agency immediately purchases loans from the with of city budgetary funds earmarked for this purpose.

Notwithstanding the numerous problems, significant progress has been achieved in the development of mortgage lending in Russia by other commercial banks. The banks' interest in such operations appears to have been driven by two factors: first, the effective current demand for long-term housing loans, and second, the perception of an enormous future market for mortgage loans. Actual lending began in 1993. In 1994, a number of banks began as a regular practice to originate loans to individuals for housing purchase. In May 1994, *Mosbusinessbank*, one of the largest commercial banks in Russia in terms of assets, started originating long-term mortgage loans for the purchase of housing on a commercial basis to its employees. In 1994, another large

bank, *Menatep*, granted about $2 million in loans to its employees for the purchase of housing.

The task of originating loans to the general public has presented a more serious challenge, given the weak legal context of 1993-1997. Commercial banks and real estate companies in Russia worked out some successful and innovative schemes. One of these schemes ("rent – purchase") was based on the requirement only to transfer the ownership right to a unit occupied by its purchaser through a tenancy agreement at full repayment of the loan.

The results of a survey at the end of 1995 showed that 47 of the 150 banks covered by the survey had already began to originate loans for the purchase of housing. These are characterized by a short loan term (no more than one to two years), a high interest rate, and a variety of additional conditions, and are actually affordable by only 3 to 5 percent of households wishing to improve their housing conditions. Client payments are calculated to cover the full cost of a unit by the end of the rent period, including maintenance cost, rent, and interest on a hidden loan.

In the event of a payment delay, the bank simply refused to prolong the rent agreement, which usually was closed for a short term (no more than one to three months). As soon as the rent contract was terminated, the client had practically no chances to recoup the loan sum already paid, because the seller (owner) of the unit, as a rule, interpreted the received money as rent payments. The scheme, thus, failed to properly protect individual clients from bad sellers. More generally such schemes tended to be rather complicated and entail certain additional costs that made them very expensive to the borrower.

Almost 75 percent of the banks offering mortgage loans did so in both rubles and hard currency. Some 60 percent of loans were offered for less than one year. Only a quarter of the respondents proved ready to enter into long- (i.e., more than five years) term financial relations with borrowers. Interest rates ranged from 90 percent to 140 percent for ruble loans and from 25 percent to 45 percent for hard currency (US$) loans. A critical condition for obtaining a mortgage loan was high borrower's equity in the unit being purchased. Loan-to-value ratios for these loans were about 30 to 50 percent.

The most prominent performer in the long-term housing loan market was the Stolichny Savings Bank. It began loan operations in May 1994 and by the end of 1995 had originated about 1,000 loans. Its total outstanding debt on housing loans was $17 million.

Banks originating mortgage loans tried to alleviate interest rate risk by means of new credit instruments, a whole set of which appeared in 1994. For example, the *Mosbusinessbank* began to employ a deferred adjustable instrument (DAIR) for making loans using the interbank lending rate as a cost-of-funds index. Other banks attempted

to introduce an instrument that used the official minimum wage for defining a cost-of-funds index.

A second survey of interested banks conducted in early 1997, revealed new trends in the development of mortgage lending. Loan terms were now longer with some banks making loans for five and even ten years. More active use was being made of pledge of purchased housing rather than the common “rent-purchase” scheme. Experience had indicated that nonpayment on housing purchase loans was low and might be reduced to the minimum through use of prudent borrower qualification procedures.

Approved legislative principles of mortgage lending have finally opened the way for “classic” residential mortgage lending. Introduction of the “classic” mortgage scheme makes it possible to expand the lending term thus making housing loans more affordable to individual clients.

The financial crisis of August 1998 drove commercial banks to realize the necessity to diversify their activities by expanding their services in more stable segments of the financial market than securities. Today many consider retail residential mortgage lending as one of the most promising avenues for expansion. Commercial banks make loans characterized by LTV ratios of over 50 percent, interest rates vary from 20 percent to 28 percent on loans denominated in US$, and terms of repayment that are generally 2-5 years but go up to 10 years. Given the remaining high credit risk on such loans, banks have focused efforts on thorough selection and underwriting of borrowers.

INSTITUTIONS: REFINANCING INSTITUTIONS

To provide a better funding environment, the government is seeking to activate the Agency for Housing Mortgage Lending to serve as a mortgage refinancing institution. This agency was established in 1997 as an open joint-stock company with the state exercising control over its activities. Currently this control is exercised through its controlling package of shares (to date a 100 percent of the agency-authorized capital) and membership in the Supervisory Board of the Agency.

The key tasks of the Agency are:

1. Encouragement of longer term mortgage lending by commercial banks, through providing liquidity to banks involved in long-term mortgage lending,
2. Standardization of mortgage lending procedures to minimize credit risk and raise reliability of securities issued by the Agency,

3. Technical assistance to banks in the introduction of mortgage lending programs and training of banking personnel in rational mortgage lending practices,
4. Attraction of investors to housing mortgages.

The agency has proposed the following scheme of operations: It purchases mortgage loans that commercial banks have extended to private clients for a loan term of 5 - 10 years. It will then issue securities that will serve as a source of funds for the agency and also carry the guarantee of the Russian Federation Government and/or governments of the Federation subjects.

The agency is planning to issue two types of securities. One is general obligation bonds, whose issuance is regulated by Russian legislation. General obligation bonds issued by the agency will be coupon bonds (with a coupon period no less than half a year) with loan terms of 3 - 10 years. These bonds will be secured by agency resources mostly invested in mortgage loans (in so far as the agency operations will be actually limited to purchase of rights to claim on such loans). However, in the current economic and legislative environment, the bond issues will also need to carry guarantees of the federal or sub-federal government.

The other type of security is mortgage-backed securities. Issuance of such securities will not be feasible without development of a proper legislative and regulatory framework and investors' interest in the purchase of new financial instruments.

In 1999 the agency launched a pilot project refinancing housing mortgage loans extended by Saint Petersburg banks to private clients. The city administration of Saint-Petersburg as a subject of the Russian Federation issued guarantees to back the debt commitments issued by the Agency for mobilizing additional resources (US$ 30 million).

Commercial banks will continue to service loans purchased by the agency on a commission basis. The risk of loan default will be borne by the bank originating the loan, through required buy-back of any defaulted loans. This of course, leaves the agency carrying the risk that the bank itself will fail.

The Saint-Petersburg pilot project suggests that banks will make mortgage loans that are fully consistent with agency standards and requirements. The first mortgage loans were signed on March 1, 1999 for amounts ranging from 6 to 35 thousand US$. Interest rates varied from 15 to 18 percent in US$ and the loan term was 10 years. Loan-to-value ratios could not exceed 70 percent of the market value of the mortgaged property, effective on the date of loan issuance. Comprehensive loan underwriting was a compulsory component of mortgage lending procedures, including a maximum allowed ratio of payment to income (possibly with co-borrowers) of 30 percent to 35 percent.

As noted above, the Moscow municipality has launched its own mortgage refinancing program. The city government is expected to subsidize it out of its own budget, the difference between the proposed 10 percent fixed interest rate on such loans and current market rates of 18 percent to 20 percent. In light of the shortage of the city budget resources necessary to repurchase loans from banks, it is not surprising that within a year only 15 loans have been made on these terms.

MORTGAGE DESIGN

The currency-denominated loan has become the most widespread instrument of mortgage lending. Commercial banks in capital cities of Russia—Moscow and St. Petersburg—use mainly this type of loan. Dollar-denominated settlements enable banks to protect themselves from inflation and ruble devaluation risks and prevent the unpredictable fluctuation of interest rates.

Before the August 1998 financial crisis most loan products offered by Moscow banks were dollar-denominated with interest rates fixed at 22-27 percent. The borrower made regular payments in rubles at the current exchange rate. This instrument appeared to be rather effective during the periods of comparative equilibrium in the ruble-to-dollar exchange rate, when many companies pegged wages paid in rubles to the US$ exchange rate. In such circumstances, the loan instrument with a dollar-denominated fixed interest rate was rather attractive for individual clients because it enabled them to specify their payments in advance.

The financial crisis has dramatically changed the employment market in major cities, to say nothing of small cities and towns. A significant decline in personal incomes and the unpredictable behavior of the ruble exchange rate (which shows a persistent downward tendency) have increased the credit and currency risks associated with the use of the currency-denominated loan instrument with fixed interest rate.

Despite declining prices and effective demand for housing, banks have attempted to continue their operations on the mortgage finance market. By employing different indexes, banks are also attempting to reconcile changes in the cost of bank funds with changes in interest rates on loans. Because of the absence of official information on financial indices reflecting the cost of funds, they attempt to use other, more public-friendly indicators, such as the US$ exchange rate or minimum wage fluctuations, which do not always correlate with changes in the market cost of funds.

City administrations are seeking for an alternative to traditional currency-denominated instruments. However, the intricacy of instruments with negative amortization of the principal, plus unpredictable payments or other loan parameters behavior hinders widespread adoption of this instrument.

SUBSIDIES

The evolution of housing subsidies was outlined above. This section describes Russia's current subsidies in greater detail.

New Municipal Housing

Despite the end of the socialist housing system, one of the major forms of housing subsidies is still direct financing of residential construction from federal and local budgets, with allocation of new units to people from the "waiting lists". This is the traditional policy of the state and municipalities to solve the housing problems of people living in poor quality, small units. Such construction has decreased by nearly 75 percent since 1990, (from 1.3 million in 1990 to 344,000 in 1998), but it is still a significant share of production and the largest part of the housing subsidy pool. The units allocated free of charge by municipalities to those on waiting lists includes vacant old units from municipal housing stock. Some people are removed from the "waiting lists" (it is difficult to estimate the exact number) through demographic change. For example, family size may decrease due to divorce, death, and other factors.

Lump-Sum Subsidies

Municipal Up-front Subsidies

The chief alternative to the municipal construction and allocation program has been a lump-sum(up-front) housing subsidy scheme on two levels—municipal and federation. This type of home purchase subsidizing is currently being used in many Russian cities (from 10 to 30 percent of municipalities depending on the estimate), but the volume of such subsidies remains small. Municipalities have the right to specify the terms of the housing subsidies provided, or to start their own programs with their own mechanisms. However, most municipalities use the parameters of the general scheme developed at the federal level, described below.

Generally the subsidy can be provided only to citizens registered on the waiting list. The subsidy amount is based on the price of a unit of fixed floor space for a household of specified size—i.e. "social standard of housing space" for a household (current social standard of housing space equals to 33 sq. m. for singles, 42 sq. m. for families of two persons, and 18 sq. m. per person for bigger families). The amount ranges from 5 percent to 70 percent of the average market price of housing meeting the social standard for a given household, with higher amounts payable to lower income households and those who have spent more time on the waiting list.

Table 6-2 shows a sample of up-front subsidies, as a percent of the average cost of construction or purchase price of housing, depending on years on waiting list and

income. The key objectives of the program are to take advantage of private funds in order to reduce the time a household is on the waiting list and simultaneously improve the targeting of subsidy resources.

TABLE 6-2
DETERMINATION OF LUMP-SUM SUBSIDY AS A PERCENT OF HOUSE PRICE

Ratio of per capita household income and the minimum wage amount	**Number of complete years passed from the date of registration on a municipal list of households in need of better housing conditions**															
	0	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15 or more**
4 and less	64	66	68	70	70	70	70	70	70	70	70	70	70	70	70	70
5	60	62	64	66	68	70	70	70	70	70	70	70	70	70	70	70
10	40	42	44	43	48	50	52	54	56	58	60	62	64	66	68	70
15	20	22	24	26	28	30	32	34	36	38	40	42	44	46	48	50
19	5	6	8	10	12	14	16	18	20	22	24	26	28	30	32	34
20 and more	5	5	5	6	8	10	12	14	16	18	20	22	24	26	28	30

The greatest advance in this area was made by Moscow authorities (Moscow has had much greater access to fiscal resources than other cities). Nearly half of the 450,000 households (15 percent of Moscow residents) on the Moscow waiting list expressed their wish to receive such subsidies. In 1997, the city spent more over 200 billion rubles (nearly US$ 34 million) for this purpose. At that time, the price of standard housing in Moscow was about US$ 600 per sq. m, and the average unit purchased by households had about 50 - 60 sq. m of floor space. Thus, the allocated amount was sufficient to pay only about 2000 - 2500 subsidies, with the mean subsidy amounting to US$ 17,000. (Notably, funding levels have been so low that only households on the waiting list before 1989 have qualified.)

Federal Budget Up-Front Subsidies

The second level of housing subsidies are those issued by federal authorities based on special laws and federal money. Most federal programs in this area are targeted on several narrow groups of citizens, and amount up to 100 percent of the market value of a standard unit in Russia (as defined by the “social norms” of housing).

The biggest up-front housing subsidy program financed by the federal budget is the program issuing housing purchase vouchers to retiring military officers. These subsidies are granted by way of transfer from the federal treasury through the local branch of Sberbank to the personal blocked account of the recipient, and then to the

housing unit seller account. The subsidy is duration of service (from 10 to 25 years—80 percent, more than 25 years—100 percent). The new residence may be anywhere within the territory of the Russian Federation. The voucher can be used only to buy an already completed unit on the market, which may be either newly constructed or existing.

Throughout the program's existence, from its beginning in April 1998 through August 1999, about 9,400 certificates totaling Rbls. 1.47 billion have been paid out. Another Rbls. 4.5 billion is planned to be given to this program for the 1999 budget for 23,600 certificates. The average amount of up-front subsidy per household in 1998 was Rbls. 143,000 rubles (US$ 9,500). In 1999, it is expected to be Rbls. 191,000 (but only US$ 7,650).

A similar program is targeted to migrants from the Far North regions. They are given a guarantee letter issued by respective executive authorities of the Federation Subject, indicating the total housing space, household size and subsidy amount (from 80 to 100 percent of the housing price depending on the years of service). The subsidy is not paid to the recipient in cash, but transferred from the Ministry of Finance to the regional administration and then to the appropriate developer (seller) against the housing construction or purchase contract. This transferring mechanism is different from the military program and is considered less efficient.

The 1998 federal budget earmarked Rbls. 1.2 billion to finance this program. Although last year's experience proves that the program has been substantially underfinanced, the same amount is earmarked in the 1999 budget.

All programs financed from the federal budget have a common deficiency: their eligibility criteria fail to include household income. As a consequence, they fail to relate subsidy level to the financial status of a household. However, the logic for this is compelling: The percentage of well-to-do in the targeted groups is extremely low, reducing the value of income-tested methods for selecting eligible candidates. In addition, the government is required to meet these obligations by law no matter what the financial status of an eligible household is.

Interest-Free Loans

Interest-free loans using federal budget resources are provided to citizens officially recognized as forced migrants who need better housing. Forced migrants are granted a long-term (up to 10 years) interest-free loan for the full cost of (constructed or renovated) housing within the social standard. The loan amount may not exceed actual costs of the purchased (constructed or renovated) housing. The local agency of the Russian Migration Service issues instructions to the branch of Sberbank that maintains the agency accounts. The loan money is placed into personal blocked targeted accounts of the borrowers opened with Sberbank of Russia. To get the permission to

use the loan funds, the borrowers must provide appropriate documentation for the purchase or construction performed within two weeks.

In an environment of high inflation, the present value of loan repayments will be very low and possibly negative once loan servicing costs are taken into account. Even so, this program is underfunded and quite small.

Regional Programs Based on Local Budgetary Resources

Regional programs are based on the active role of local governments in mobilizing individual savings for housing construction. Regional authorities establish special funds to support residential construction. The key objective is to use municipal (regional) budgetary funds to finance construction of residential properties, which then are supposed to be sold to residents on condition that the latter agree (a) to sell their previous housing to the fund and (b) to cover the balance partially out of cash and partially by installment payments within a year or two.

As a rule, the value of the previous housing covers 50 percent to 70 percent of the price of a new one, with the remainder repaid by the purchaser (20 percent to 25 percent) and through a credit (15 percent to 20 percent). The credit is usually provided in the form of sale by installments for a two to seven year term at 8 percent to 10 percent annual interest in rubles. (At such a low rate of interest on a ruble loan, this is a significant form of budgetary subsidy without clear eligibility criteria and rules.) This scheme is based chiefly on budgetary resources of municipalities, which, in the current environment of ballooning local budget deficits, makes it infeasible for the majority of Russian localities.

Tax Subsidies

Along with direct subsidies, several indirect subsidies are currently used in Russia. The largest is a tax deduction for the purchase of units or housing construction for up to three years. The deduction also covers loan service. An amendment to the tax law as of December 1993 established the maximum amount that could be deducted from income as 500 minimum wages; in 1994, this amounted to Rbls. 8 million (a little more than US$ 5,000 at the beginning of 1994). The income tax rates in 1994 ranged from 12 percent for an annual income below Rbls. 3 million, up to 30 percent for an annual income exceeding Rbls. 10 million. The maximum tax-exempt sum was lower than the minimum cost of housing, but the progressive tax scale provides higher benefits to households with higher incomes.

In March 1995, the government enacted amendments that increased the total volume of benefits. The maximum deduction was raised to 5,000 minimum monthly wages (US$ 60,000 at the beginning of 1995). This figure covered most current housing prices. In January 1997, it was established that the benefit could be granted

only once. In the first half of 1998, the maximum sum equaled 417 thousand rubles (about US$ 65,000 at that time but only US$ 20,000 by December 1998, after the dramatic fall of the ruble). At the same time, there was about a 30 percent decline in the dollar price of housing.

These subsidies are granted not only for new but also for existing housing. Given the fact that total housing transactions (including home purchases and housing self-construction) are estimated at 400-500 thousand per year (there are no official statistics), and on the assumption that average transaction volume is 15 thousand US$, total deductions from taxable income amount to US$ 6 to 7.5 billion. Since the maximum income tax rate for Russians is currently 35 percent, the tax subsidies could cost the budget over to US$ 2 billion per year. Actual lost revenue is probably closer to US$ 1 billion, still over 2.0 percent of the Federal budget in 1999.

Since 1994, income from the sale of residential units, family houses, or land plots is also exempt from income tax if it does not exceed 5,000 minimum wages (almost US$ 20,000 in the second half of 1998).

Another type of indirect housing sector subsidy is reduced VAT rate for construction companies involved in new housing construction projects with more than 40 percent state participation (This provision does not apply to self-construction). Discussion is ongoing about converting this subsidy into an income tax deduction for an individual borrower's mortgage loan repayment.

Combining Subsidies

The following example illustrates how a household might combine housing subsidies. A one-child family of a retiring military officer is eligible for a housing subsidy equal to 100 percent of the price of an apartment (in the first quarter of 1999, this price was US$ 144 per 1 sq. m. of a 54 sq. m apartment, US$ 7,800). The average money income of the household in 1999 is about 3,000 rubles per month, 36,000 rubles per year (US$ 1,140). If the household decides to purchase a more expensive apartment (say, 50 percent more), it must pay the difference between this and the subsidy amount. At the average tax rate for working members of the household will be 12 percent, the annual income tax paid by the household is US$ 170. Over three years, the income tax subsidy for this household will come to US$ 510. Thus, the combined subsidies provided to this household (a housing subsidy plus income tax exemption) will total US$ 8,310. The balance, 29 percent of the unit cost (USD 3,390), must be paid by the household out of its own funds.

In principle, it is also possible to combine receipt of a free-of-charge apartment (for a family on the waiting lists) with free-of-charge privatization, with a tax deduction for the further purchase of a bigger unit. However, this does not happen often, since families provided free housing are normally in the low-income groups.

In general, subsidy policy tries to eliminate the possibility of using subsidized assistance more than once. For example, housing may be privatized free-of-charge only once in a lifetime, up-front and tax subsidies are also granted only once, and so on.

OTHER FACTORS AFFECTING THE HOUSING FINANCE MARKET

In addition to past and recent history of housing policy, the institutional structure of the housing finance sector, and the subsidies that help shape the market for mortgage finance, a number of other factors affect either the demand for finance or supply (i.e., the willingness of lenders to make loans).

Demand Factors

Key factors restricting the demand for mortgage finance are a very high ratio of unit price to household income for most households, the high real and nominal cost of long-term lending, lack of public confidence in the banking system, and general economic ambiguity.

Table 6-3 shows the significant range of house price to household income ratios across cities and regions between 1994 and 1997. Ratios had fallen quite low in Moscow and below 6 in most areas by 1997. But the jumped back up in 1998 when incomes declined more sharply than prices.

TABLE 6-3
RATIO OF HOUSE PRICES TO AVERAGE HOUSEHOLD INCOME, ACROSS CITIES AND REGIONS

Cities and regions	1994	1995	1996	1997	1998*
Moscow	6.0	6.6	3.2	2.6	5.7
Saint-Petersburg	4.7	5.0	4.9	5.3	8.9
Nizhny Novgorod region	5.7	9.6	7.8	8.7	9.7
Samara region	7.6	12.9	9.0	6.3	8.4
Saratov region	4.4	12.6	8.3	5.9	7.2
Irkutsk region	5.1	6.0	5.2	4.4	6.7

* 1998 – estimated

Rapid inflation (at a 54 percent annual rate in the first half 1999), high ruble interest rates and bank costs, and perceived and real risks all dictate a high margin on retail mortgage lending. For example, Sberbank currently originates ruble mortgage loans at 42 percent. With average per capita income in Russia equal to 1000 rubles (US$ 40) a month and only 35 percent of residents having incomes above the average, such loans are affordable by only a very small fraction of households.

Dollar-denominated loans appear to be more affordable. But they are associated with higher interest-rate and credit risks (with most bank liabilities and incomes denominated in rubles). The low access of Russian financial institutions to foreign resources makes the cost of medium-term currency resources about 13-14 percent. Together with the other reasons for high margins, this leads banks to originate such loans at a minimum of 18-20 percent per annum and sometimes up to 25 percent.

The last but not the least factor inhibiting demand is psychological. The drastic fall in personal incomes of the majority of the population caused by the August 1998 crisis, and second major loss due to significant devaluation of individual bank deposits (the first coincided with the 1992 price liberalization) add up to psychological uncertainty that constitutes a distinct disincentive for the public to make long-term financial and economic decisions.

Supply Factors

The following factors are key reasons for the banking sector's reluctance to engage in mortgage lending: inadequate legislative and regulatory framework; lack of long-term lending resources; and lack of the expertise and reliable mechanisms necessary for efficient operation of the mortgage market.

Despite enactment of important new laws, the mortgage and tax legislation currently on the books, as well as statutory acts governing banking sector operations in both primary and secondary mortgage markets, still have serious gaps. Of particular importance is development of an adequate regulatory framework to provide clear guidance on rules and court procedures for foreclosure on mortgaged property and eviction of households of defaulted borrowers with minor children or other dependents. In the absence of such precedents, banks are seeking guarantees that all legislative requirements will be observed and they will not have to keep bad loans in their portfolios. With this aim in mind, several regions are currently involved in designing social protection mechanisms, including creating low-quality housing stock for borrowers and their households to permit continued housing in case of eviction.

The shortage of long-term lending resources is important, because the short-term liabilities that are most banks major source of funds, are historically too unstable to permit much mortgage lending. In such a situation, creation of a window for refinancing and a market for mortgage securities has become of paramount importance.

Outstanding issues related to development of the Central Bank bylaws include guidance on how to assign rights to mortgage loan claims, how to service loans purchased by a secondary mortgage market operator, and how to analyze and assess credit risks and include them in the accounting system and reports currently used by primary and secondary mortgage lenders. Considering the fact that Russian banks have never before been involved in assignment of mortgage loans on a wide scale, it is

particularly important to develop an optimum system of taxation of the earnings produced by such transactions. Of similar importance is rationalizing procedures for issuance of mortgage-backed securities.

One more factor constraining banks' operations on the mortgage lending market in a major way is their inexperience working with clients and prospective borrowers. At present, the Agency for Housing Mortgage Lending is deeply involved in refining procedures for the origination and servicing of mortgage loans. The intent is to minimize risks associated with mortgage lending, introduce clear mortgage lending standards, and furnish banks with standard agreements forms and account documents.

Despite these problems, banks are showing growing interest in mortgage lending operations, regarding them as a reliable component of their lending activities. Mortgage lending has become particularly important to them since the 1998 financial crisis and collapse of the GKO market, which has deprived them of one of the most important sources of easy earnings and pushed them to search for new fields of banking activity.