ANNEX A. SUMMARY OF THE MEETING *

Introduction

The Workshop on Housing Finance in Transition Economies was held at the OECD headquarters on 14-15 December 2004, which was organised by the Outreach Unit for Financial Sector Reform, Directorate for Financial and Enterprise Affairs of the OECD, under the aegis of the Committee on Financial Market and the Centre for Co-operation with Non-Members programs, with sponsorship from the Government of Japan. The objective of the workshop was to provide a forum for relevant policy makers, representatives of the private sectors and other experts to exchange information and experiences in the field of housing finance.

The workshop reviewed the current stage of mortgage markets in transition economies and assessed the steps needed to develop their markets. The discussions focused mainly on five issues: 1) overview of mortgage markets in the region; 2) effective housing finance systems for the low-income market, which focused on housing finance availability for low-income households and government subsidies for housing; 3) safety and soundness of mortgage markets; 4) innovations in mortgage insurance; and 5) development of different secondary mortgage markets and instruments, which focused on mortgage covered bonds.

The workshop was attended by around 80 participants who were policy makers and experts from 13 non-member countries (Azerbaijan, Croatia, Estonia, Georgia, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, Mongolia, Russia, Slovenia, Ukraine and Uzbekistan), 12 member countries (Belgium, the Czech Republic, Denmark, France, Germany, Hungary, New Zealand, Poland, the Slovak Republic, Turkey, the United Kingdom and the United States) and 3 international organisations (European Commission, European Mortgage Federation and World Bank). **Mr. Torben Gjede**, Director General of the Association of Danish Mortgage Banks, moderated this conference as a chairman.

Before starting the session, **Mr. William Witherell**, Director of the Directorate for Financial and Enterprise Affairs of the OECD, and the chairman made their opening remarks, addressing the critical issues to be solved in the current housing finance markets in transition economies and the importance of mortgage lending that makes use of the property as collateral.

1. Overview of Mortgage Markets in Transition Economies

Capital market and banking sector reforms have been proceeding at different speeds in transition economies. In comparison, housing mortgage markets in the region are typically small in scale and under developed, where deposit based lending is still predominant in most of the countries. Also, funding through secondary market such as mortgage covered bonds has just started in the region.

* This summary was prepared by Shigehiro Shinozaki, Administrator of the Directorate for Financial and Enterprise Affairs, OECD.

Through the room discussions, several progresses of primary and secondary mortgage markets were seen in transition economies but most of the markets still seemed to rely on the government subsidy. Enforcement of market regulations also seemed insufficient in the region.

First of all, **Mr. Shigehiro Shinozaki**, OECD Secretariat, examined the potential for housing finance markets in Central Europe in comparison with the EU 15 countries. The study countries were Poland, Hungary, the Czech Republic and the Slovak Republic that joined the EU in May 2004. It was a good opportunity to review their markets since over six months had gone by after their accessions to the EU. Their housing finance markets were mainly assessed in terms of the supply and demand of housing, primary and secondary mortgage markets, and regulations and housing policy.

The following main trends were pointed out during the presentation. Firstly, housing policies based on government subsidies have not succeeded in boosting housing demand in Central Europe. Some government support measures for housing seem to be cost inefficient; e.g., the savings bonus scheme, the large portion of which is not used for housing purpose in some countries. Secondly, low demand and insufficient supply of housing exist in the region. Macroeconomic conditions such as high house price inflation, low income and high unemployment rate are not supportive for the creation of housing demand while housing supply has not well targeted average households. Thirdly, the mortgage lending market has been rapidly growing in Hungary, which is backed by the active secondary market funding (mortgage covered bonds) and government support through subsidy. By contrast, the mortgage lending markets have been less developed in other countries though the markets are growing, where deposit based lending remains predominant. Lastly, enforcement of market regulations is still insufficient as compared to the progress of overall financial sector reform. Although all countries have basically fulfilled the EU directives such as UCITS, their markets still have weaknesses; e.g., information asymmetry, insufficient electronic land register, etc. From the aggregate result, it was also pointed out that a key step towards the development of the Central European housing finance market might be a risk-based mortgage lending system supported by a securitisation scheme, targeted to low- and middle-income households who have been little targeted so far.

From the European Mortgage Federation, **Mrs. Annik Lambert**, Deputy Secretary General, introduced the current EU mortgage markets and the legislative situation. Residential mortgage markets in the EU area have been fastest growing over the last 10 years, which average growth rate is approximately 8% per annum. The total residential mortgage loans outstanding in the region was EUR 4.2 trillion (EUR 5.1 trillion if including non-residential mortgages) in 2003, which doubled as compared to the early 1990s. Residential mortgages in EU15 represent approximately 45% of the EU GDP but those in new EU member states (EMF members) do only 5.5%. Debt to GDP ratio in the northern part of EU is higher than in the southern part. By contrast, home ownership levels in the southern part of EU and Hungary are higher than in the northern part (EU15 average: 64%). Mortgage credit interest rates have been sharply converging since the Euro was introduced in the EU markets. House prices, however, have been increasing in most countries. Funding techniques are increasingly becoming a competitive issue in the EU markets. Remarkable trend of the markets is that the largest five national lenders account for over half of the mortgage loans outstanding in respective EU countries (EU average: 24%, especially Denmark: over 80%). Major lenders in the EU area are universal banks and/or commercial banks, which market share was 41% in 2001. As a whole, European mortgage markets are broadly efficient but differentiate in, for example, product range, the set of borrowers served, levels of transaction cost and collateral efficiency, funding methods (savings, mortgage bonds or MBS) and government involvement (direct or indirect, through regulation, tax and subsidy). The fundamentals for an efficient and integrated housing finance system are five-fold: 1) sound macroeconomic policies; 2) low transaction costs and efficient mortgage collateral; 3) efficient

primary market (e.g. protect property right, etc.); 4) transparent markets and consumer protection; and 4) standardised funding instruments to tap capital markets.

With respect to the legislative situation in the EU, credit institutions, which include mortgage lenders, are thoroughly regulated by the 1989 2nd Banking Directive complemented by numerous specific directives. The regulatory situation is different by products; i.e., consumer loans (consumption) are regulated at both national and EU level while the regulations on mortgage loans (housing) are based on 1) commission recommendation endorsing the Code of Conduct for Home Loans (self-regulation), 2) national level, and 3) horizontal consumer protection regulation applying to financial service in general. There is currently a political debate whether or not product harmonisation would achieve greater integration of EU mortgage markets and if this is the case what should be the principle for harmonisation; minimum (minimum set of common rules) or maximum (higher level of harmonisation). This issue was caused by the debate that the 2nd Banking Directive failed to achieve a single market due to intrinsic limitations; i.e., mortgage borrowers are protected at both national and EU level through horizontal regulations while mortgage loans are not regulated at EU level. Another debate is that the mortgage industry opposes any attempt to regulate certain mortgage loans in the 1987 Consumer Credit Directive based on minimum harmonisation because of the opinions that mortgage loans are different by countries and that all mortgage loans should be subject to one single set of rules.

As a representative of countries that recently became EU members, **Mr. Jacek Laszek**, the National Bank of Poland, reviewed its housing finance market after the accession and discussed its challenges. The Polish housing finance market has been growing since 1994 (the total portfolio: PLN 45 billion), though the market is still small in scale as compared to the advanced EU countries. For example, the share of housing loans to GDP is around 5% (2003), loans to banking assets is around 8% (2003) and loans account for 45% of new construction (2004), all of which are sharply growing. However, housing loans portfolio to total housing stock value is still below 1%. Major factors of the successful development are two-fold: 1) economic stabilisation backed by the decreasing inflation and interest rates and the optimism of customers; and 2) privatisation of the banking sector with market-based state housing policy (relatively little depending on the subsidy) and international programs provided by the World Bank and the USAID.

Main characteristics of the Polish housing finance market are as follows: 1) large universal banks dominate the market (PKO BP: 35% market share in 2003); 2) high share of indexed loans (dual indexed such as DIM or foreign currency denominated such as EUR, CHF and USD, the latter is growing), which account for approximately 60% of the market; 3) variable rate mortgage (WIBOR 3M, 1M) with the declining margins and the amortisation up to 30 years; 4) funding relying on short-term deposit (3-6 months); and 5) no depending on the contract savings scheme (KM system was stopped in 2001 though it exists legally, which was directly connected to the subsidy program that the government stopped.). Currently, in Poland, issues to be solved and challenges are to enhance 1) the access to capital market (mortgage bonds laws are restrictive and MBS laws are incomplete due to the complexity of the system), 2) supervision on risk-based housing finance system, 3) consumer protection, and 4) housing finance affordability for selected social groups (insurance vs. savings systems, targeted to subsidy systems, etc.).

Considering the effects of new EU members on European mortgage markets, **Ms. Harsha Shewaram**, Internal Market DG of the European Commission (EC) discussed the Commission's interventions towards a single mortgage market in Europe. Mortgage credit policy is high priority in the EC because of the following facts: 1) residential mortgage credit is big business in Europe (growing markets); 2) the markets are very varied (far from being integrated into an EU single market); 3) there

are little cross-border activities; and 4) there is an increased focus on the potential for further integration of retail financial services markets.

Currently, there are no EU legal instruments directly covering mortgage credits. Against this backdrop, the first intervention by the EC is a recommendation endorsing the voluntary Code of Conduct on pre-contractual information on housing loans. So far, approximately 3,800 mortgage providers have signed up the Code but the actual compliance level is not satisfactory. The Code covers only one aspect of the mortgage transaction; i.e., pre-contractual information. This Code is an option for new EU member states. The second intervention is the Forum Group on Mortgage Credit, which was set up in March 2003. The mandate of the Forum Group was three-fold: 1) identify barriers to integration; 2) assess the impact of barriers on integration; and 3) make recommendations to the EC to tackle these barriers. The Forum Group undertook this task by focussing on 5 main areas: 1) consumer confidence (consumer protection); 2) legal issues (client credit-worthiness, forced sales procedures, valuation of properties and conflict of laws); 3) collateral issues (registration/transfer of mortgages); 4) distribution (distribution mechanisms) and 5) finance (financing/refinancing models). The Forum Group Report was published by the EC in December 2004, making 48 recommendations to the EC (mostly unanimous). The recommendations cover a mixture of legal and other initiatives, including calls for harmonisation in particular areas, but also general cooperation and information sharing measures. The 48 recommendations are to be assessed as a package. The EC is reviewing these recommendations and will issue a Green Paper (consultative paper) providing its initial reactions in summer 2005. The EC has also commissioned an independent study on the costs and benefits of further integration of EU mortgage markets, which will be issued in autumn 2005. Both the Forum Group Report and the study, together with on-going consultation, will assist the EC in considering whether or not EU action is merited in this area.

As a representative of EU candidate countries, **Mr. Mladen Mirko Tepus**, Croatian National Bank, reviewed the progress on its housing finance market. Croatia became an official EU candidate in June 2004 and the negotiation with the EU should start in the nearest future. Regarding the Croatian housing market, there are some issues to be solved against the marked demand for housing; i.e., overpopulation of some dwellings, shortage of housing stocks in large towns, low housing standard (27.6m^2/person in 2001) as compared to the EU level, necessity of renovation for a number of dwellings and buildings, and marked demand for social housing. Rental housing market is poorly organized backed by the grey market (it seems to be easy for informal income group to avoid to pay the tax in this system). Housing prices have been increasing (22-30%) against the low income condition of households.

On the other hand, however, accessibility to housing finance for households has been improved. In fact, the ratio of housing loans to GDP is nearly 10% in Croatia, which is the highest among transition economies. In the housing finance market, commercial banks enjoy the dominant status (99% market share), where the eight largest banks account for over 80% of total housing loan assets. As innovative loan products, the CHF indexed loan and the repayment-free model have been developed recently. Major funding methods still rely on deposits but the possibility of secondary market funding is expected to be examined in the near future. Also, Housing Savings Banks (HSB) appeared in the Croatian market in 1998, which is similar to the German *Bausparkassen* system. Interest rate spread is limited by 3%. Minimum savings period of 2 years is required for loan application. Deposits are 100% insured up to HRK100,000 (USD 16,507). Through the distribution channels (multi-level salesman network, licensed sales office, cooperation with banks and internet), housing finance by HSB has been sharply growing since its establishment, though its market share is still around 1%. As a government support measure, the Government-Supported Long-Term Financing Fund was established in 1997 but is not active any more. Instead, the Socially-Supported Government Housing

Construction Program (POS) was introduced in 2001. This is an attractive model to stimulate housing finance accessibility for households but quite subsidised model, which is an issue to be solved in the future. In this subsidy scheme, sales price of dwellings is limited to EUR 910/m^2. In 2005, reforms for rationalisation of the tax system are planned.

During the discussions after this session, questions concentrated on the Polish housing finance system little relying on subsidies, the growing Croatian contract savings scheme (HSB), recommendations by the Forum Group on Mortgage Credit (harmonisation issue) and the Code of Conduct (low compliance). One of the interesting questions was how the HSB will well compete with universal banks in Croatia taking account of liquidity concerns. It seems that HSB well manages interest rates (e.g., via CHF) to compete banks. Regarding the Code of Conduct, 14 countries out of EU15 (i.e., except for Spain) have adopted it but the implementation level is not the same in respective countries. Among new EU member states, Hungary has quite advanced in this regard.

2. Effective Housing Finance Systems for the Low-Income Market

Mortgage lending is not so active in transition economies, which is mainly caused by the dominance of deposit-based lending and the vulnerability to serious credit, liquidity and interest rate risks. Generally speaking, transition economies have yet to stabilise their economic conditions, though the situation has been sharply improved in the region. Against this backdrop, existing housing finance systems tend to be underserved to low-and middle-income households; i.e., limited access to housing finance for low-and middle-income households. In this context, the discussion focused on two issues; housing finance availability for low-income households in the region and government subsidies for housing.

2.1. Housing Finance Availability for Low-Income Households in the Region

In transition economies, several issues can be considered limiting the supply and demand of housing finance; e.g., difficult foreclosure, uncertain formal and informal incomes, unreliable appraisal, absence of instruments to mortgage market risks, absence of mortgage insurance, etc. Expensive housing assets also cause the discussion on housing price affordability versus housing credit affordability, which is often attributed to supply bottlenecks related to urban development policy and land. Due to the low quality of housing stocks in transition economies, home-improvement loans for upgrading housing stocks will be an important housing finance product for low-income households in the region. The establishment of a proper financial scheme to rental housing will be also an important issue for them. Although there is no single model of housing finance for the low-income segment, this section considered effective models of housing finance for them in the region.

Mr. Loïc Chiquier, the World Bank, suggested some implications of useful tools on housing finance for the low-income segment. Housing finance has visible and recognised socio-economic impacts in transition economies but residential mortgage debts account for only 2-8% of GDP in new EU member states. Against this backdrop, there are some positive factors in the markets; i.e., competing retail banks through mortgage markets, EU convergence and improved macro-stability, extended maturities, high LTVs, reduced interest rates and margins, and stretched credit affordability conditions. Those factors bring the low-income segment the favourable conditions to access housing finance, but it is significant to well manage specific risks such as credit risk, liquidity risk and market interest rate risk as housing portfolio expands to the low-income households. It will be worth considering the Basel II as a credit risk management tool. In this context, it should be noted that it is difficult to design affordable and sound housing loans within different macroeconomic conditions (e.g. fixed or variable rate mortgages). Also, there are some issues with legal and regulatory framework; i.e., issues with foreclosure, title registration and co-ownership structure (multi-family apartment).

Taking account of disputable programs such as subsidised credit rates and saving premiums, much smarter subsidy schemes will be necessary in transition economies.

As a possibility, the concept of microfinance applied to housing will be worth noted. It is a relatively recent concept notably in Latin America and Asia (e.g., Bolivia, Peru and Vietnam) but does not exist in transition economies at present. In Latin America, mortgage system crashed in the 1980s and 1990s due to the big macroeconomic shocks, where the mortgage system targeted only higher income people. Therefore, the governments considered how to reach low-and middle-income groups to revitalize mortgage markets, which resulted in the development of microfinance in Latin America. Housing microfinance is a concept to provide certain kind of clients such as un-banked informal income groups or people who are not able to get mortgage loans from banks with small loans and terms (less than USD1,500 or equivalent, 2 years) without mortgage lien, which is mainly used for home improvement and progressive housing. Main lenders are microfinance institutions (MFI) and NGOs but its concept has been attracting commercial banks recently. Commercial banks are also creating own MFI or purchasing MFI because of its profitability. However, microfinance is very costly, which interest rates are quite high reflecting high information costs. Also, for funding, micro-lenders do not tap capital market and do not have deposits. There are some issues in the microfinance system: lending regulations, pre-saving, "natural" affordability limits, access to sustainable funding, and distorting or leveraging subsidies.

Furthermore, mortgage credit insurance systems, which reallocate credit risks, will improve credit affordability for low-income people via high LTV. Mortgage insurance is also useful to enhance mortgage securities markets (mortgage bonds and MBS, attracting institutional investors). It is cheaper than most conventional interest rate subsidies, but specific insurance regulatory framework will be necessary. Also, it is worth considering the European reinsurance system, which will help to access housing finance for low-income households.

Savings products involve some questions. Lenders need to build down payment and favourable credit score for lower and/or informal income groups. Informal groups typically may not have own bank accounts, where a question is how savings products develop in the situation of lacking information.

Rental finance will be a key element of affordable housing policy in EU but is less considered by policy makers in most transition economies after the privatisation of the housing stocks. Rental finance is particularly important for urban, younger, mobile and vulnerable groups, and for liquid housing markets and labour markets. There are many legal and regulatory obstacles in the rental market; 2nd generation of rent controls, protected tenants, unfavourable tax treatment for retail investors, less subsidies for tenants, and needed efficient property management structures. In Poland, a public program for new rental has been working via non-profit association since 1997. About 50,000 units were built in this program but heavily subsidised, which depressed private rental markets.

In transition economies, mortgage securities such as mortgage bonds and MBS have yet to be well developed, where depository universal bank model is still dominant. However, taking account of recent reforms of pension funds and contract savings schemes in the region, there will be a great opportunity of growing mortgage securities from an investor point of view, which is a key challenge to tap capital market for transition economies.

Dr. Friedemann Roy, Germany, stressed the benefits of contract savings schemes for housing (CSH) from a viewpoint of low-income households. CSH is a traditional funding mechanism in housing finance, which links a saving period to the promise of a housing loan with fixed rate below market rate. European CSH schemes consist of two systems: 1) closed system (e.g. Austrian and German *Bauspar* system; Croatia, the Czech Republic, Hungary, Romania and the Slovak Republic) and 2)

open system (mixture funding system of savings with external funding; France and Slovenia). Those schemes are relatively well regulated and supervised typically with state support of savings bonus and/or other incentives (e.g. tax relief). In the initial stage of transition, CSH was popularised in the region because of lack of long-term funding instruments and limited access to mortgage finance for young family and low-income households. Now the introduction of CSH has some debates in the region in terms of the system benefits. From an economic point of view, volatile inflation and unstable employment patterns in transition economies will impede savings activities. However, specific risks such as credit risk, exchange rate risk and interest rate risk are relatively well managed because of the design of CSH system (savings requirements, contracts in one currency, etc). The CSH contract value is correlated to the customer's expectations of interest rates. In the design of CSH, the government has two functions: 1) emphasis on prudent legislation and tight monitoring of CSH to build up confidence, and 2) government support of savings bonus (debatable).

There was a discussion which systems of the open and the closed system would be a preferable model in transition economies. One has an opinion that the closed system is preferable in the early stage of transition because of relatively easiness to seize the system with transparency while another objected it because of its high liquidity risk and supply constraint (impediment of cultivating new borrowers) mentioning that closed system should be converted to open system (semi-open system; creating savings with indexed loans) in inflationary economies.

Mr. Alexander Kopeikin, Institute for Urban Economics in Russia, explained the recent legal efforts for the housing finance affordability in Russia. At present, housing finance system for low-income segment has yet to be developed in Russia. Household income has been sharply increasing recently, but on the other hand, housing price has traced the same trend. On supply side, new construction has been decreasing, which is almost a half volume compared to the Soviet era (80 mil. m^2 to 36 mil. m^2 in 2003). Although household demand for home loans was anticipated USD 3.78 billion, the housing loans outstanding was only USD 1 billion in 2004. Against this backdrop, several problems were identified: low effective demand for housing, high interest rates on home mortgage loans, inadequate supply of housing, high transaction costs on the housing and mortgage markets, and inadequate security of rights of homeowners and investors in housing construction projects. To solve those problems, Russia has currently tackled overall legislative reforms for housing affordability. In general housing policy, the draft Housing Code includes regulations on social and commercial housing rent, homeownership, and residential property. On demand side, the creation of a favourable legal environment for the development of housing mortgage lending, implementation of housing savings programs and other forms of effective demand promotion has been considered via amendments of civil, civil procedure, mortgage, mortgage securities, insurance and other related Codes and laws. On supply side, it is expected to stimulate the growth of housing construction, to facilitate the access to land resources, and to develop engineering infrastructure, through drafts of Town Planning Code, laws on investment agreements and tariff regulation, and the amendments of Budget Code. In the market transactions, amendments of civil and registration laws are expected to stimulate reduction of transaction costs and homeowners' risks to lose homeownership, and to promote competitive pricing and reasonable price stabilisation on the housing market. Also, preferential tax provisions will support the housing affordability: VAT, profit tax, income tax, land fee, state duty, and local real estate tax.

After this session, in the context of state support measures, there was an opinion that every subsidy impacts housing price because it pushes the demand of housing. For instance, in Hungary, housing price has been sharply increasing after a new subsidy for younger family was introduced.

2.2. Government Subsidies for Housing

Taking account of economic and social conditions in transition economies, government support for low-income households to improve their housing-quality and to achieve home-ownership will be important as well as support to improve the efficiency of mortgage markets in the region. Typical support measures for home-owners could be direct and indirect government subsidies for housing, favourable tax treatments for purchasing houses, and provision of education (training) to borrowers and lenders. Government subsidies to rental housing are mostly benefiting the middle-income segment. It is important to focus attention on how to design, implement and monitor government subsidies to be efficient, transparent and fiscally sustainable, without creating severe market distortions and market disincentives.

Dr. Marja Hoek-Smit, Wharton School of the University of Pennsylvania, discussed the general framework of housing subsidies. Housing affordability problems are crucial issues to be solved in transition economies. The problems on the supply side will be the availability of land, cost of land, property right registration, etc., while demand side constraints are related to low income levels relative to house-prices and skewed income distributions. Access to finance is critical to stimulate housing supply and to extend housing affordability. Housing policies such as sector specific micro policies (including subsidy policies) are most important in improving the efficient operations of housing markets and housing finance systems. Even in higher income countries, formal housing supply will remain inadequate if the regulatory and policy environment do not stimulate private sector participation. Getting the policies and market incentives right in emerging economies is a critical task for governments. The first task of government is therefore to improve housing market efficiency, by ensuring that property right and registration systems, infrastructure systems, and land management systems, work well. Only then can subsidies be effectively applied. Frequently, however, subsidies are used to pay for housing market inefficiencies. Government needs a careful diagnosis of the main problems in the housing finance system that might warrant subsidies and of problems encountered by households in different segments of the market to understand how subsidies might address those problems. Countries should be weary of simply imitating subsidy schemes that are applied in other countries and that may not be appropriate to solve the housing problems of their countries.

Generally, there are three core principles for good design of housing subsidies: 1) the opportunity cost of subsidies should be known not just for the present but for future years (preferably subsidies should be shown on the budget each year, i.e., be transparent), 2) subsidies should be efficiency in the sense that the cost per unit/household should be as low as possible and the subsidy should not provide households or lenders with inputs that does not change their behaviour (i.e., they would have done the same thing without subsidies), and 3) subsidies should be equitable. For instance, a tax subsidy, which allows a deduction of mortgage payments from income for tax purposes, typically benefits higher income households more than low-income households. Many subsidies currently used in transition economies (e.g., interest rate subsidies, tax subsidies, and savings-linked subsidies in closed systems) are not transparent, equitable or efficient and are not sustainable in the long run.

There are three main objectives to subsidise housing finance systems: 1) address incomplete credit markets (e.g., expand information, share lending risks and compensate for high transaction costs), 2) improve funding systems (e.g., share liquidity or interest rate risks), and 3) improve the strength of the collateral (e.g., infrastructure and home-owner education). Effective subsidy reforms are often needed to eliminate monopolies by subsidised state (or sometimes private) housing finance institutions which were often initiated during periods of macroeconomic volatility or poor market conditions that no longer exist.

Thus, five international lessons can be summarised: 1) make sure all parts of the housing finance system work as efficiently as possible; 2) efforts to increase affordability by improving access to housing finance and housing finance subsidies cannot succeed if the housing and housing finance system are not efficient; 3) instead, these efforts will drive up prices; 4) sequencing of reforms and system subsidies is critical; and 5) housing system failure leads to rent control, need for additional subsidies, and resource misallocation.

Mr. Achim Dübel, Financial Services and Policy Consulting in Germany, discussed the different practices of interest rate subsidies, introducing Central European cases. In comparison between market interest rates and rates after government support, Poland is relatively a low subsidised market while Hungarian market is highly subsidised (market rate to rate after support in 2003, 8.1% to 6.4% in Poland, and 10.5% to 3.0% in Hungary).

In the Czech Republic, interest rate buy-down program is relatively reasonable, which is accompanied with pros and cons: 1) Pros: sustainable since rate decline triggered elimination of subsidy in 2003; cap on subsidy limits fiscal risk; and 2) Cons: lag structure of subsidy formula leads to unintended variations in after-subsidy rates; there is a risk that rates rise again rather than drop perpetuating an untargeted subsidy program. On the other hand, however, Bauspar subsidies are getting out of control, where there is no adjustment of deposit subsidy between 1992 and 2004 (huge overinvestment in CSH deposits) and the fiscal cost is 0.55% of GDP when total formal housing policy budget does not exceed 0.9% (2003). Regarding those points, a Czech participant commented that housing policy would involve a political part of views that was not always reflected on the efficiency accurately.

In Hungary, mortgage market subsidies have cumulated to the record level. Against this backdrop, there are some observations: 1) high market rates due to fiscal problem and exchange rate policy; 2) but high homeownership rate, large power of mortgage lenders and weak housing policy formulation; 3) family and social investment allowance and income tax credit for entire mortgage debt service; 4) support for mortgage banks buying mortgage portfolio (1%) and tax support for mortgage bonds; 5) mortgage bond related system of interest rate buy-down but here the affordable rate was set at 5% (new) and 6% (existing), which is the lowest among transition economies (e.g., Poland 9%); 6) "mistakes" in the formulation of the buy-down lead to rate drop to 3% in 2002, leading to cohort costs of the 2002 vintage ALONE of 1.5-2% of GDP; 7) mismatch with housing sector problems, which centre largely on modernisation, rental and rural; and 8) due to lax fiscal discipline and large deficits, Hungary can be seen as jeopardizing the access to the EMU. Regarding those points, a Hungarian participant commented that subsidised rates should be compared with long-term mortgage rates and that the current Hungarian situation of relying on interest rate subsidies would be changed taking account of the fact that Hungary is on the convergence process of Euro.

Also, rental sector subsidies will be a better target in transition economies. Rental housing sector has pivotal importance for mobility and affordability, where many transition economies involve the problems. Rental housing policies require rent reform, legal reform (tenant-landlord relations), tax reform to tap new investors, and support strategies for vulnerable households. Poland is most active in this sector.

Mr. Andriy Kyiak, National Bank of Ukraine, introduced the Ukrainian housing finance system, focusing on state activities. Recent macroeconomic conditions support the housing finance market in Ukraine. All long-term deposits, long-term loans and commercial loans have been growing during 2001-2004. Mortgage loans accounted for 1.1% of GDP. Top 10 commercial banks represented over 75% of total mortgage loans outstanding. New mortgage products have been developed, increasing maturity (10 years) and reducing interest rates (USD: 12-16%, UAH: 18-21%). Foreign currency denominated loans account for 76% of the total residential mortgage portfolio. The demand for

residential mortgage loans, however, tends to decrease as house prices grow (Kiev: 250% growth during 2001-2003). The problems of residential mortgages will be the lack of mortgage lending history, high prepayment risks, absence of flexible rate mechanism, etc. Against this backdrop, the government has made efforts to improve market infrastructure, state supervision, and state cadastre and limited rights on immobility. Besides, the government is currently examining the feasibility of new refinancing mechanisms, namely, mortgage securities (MBS). As a state subsidy scheme, the State Fund on housing construction for young people operates in Ukraine, to which over UAH 100 million was allocated from the state budget to compensate interest rates.

In the discussion session, there was an opinion; subsidies tend to be working to benefit low-income groups, which in fact contributed to mass privatisation in transition economies, but the problem is the liquidity of housing, and also subsidies typically take place to higher income groups, which will cause social regression. Another opinion was that state subsidies should be decided depending on the objectives in respective countries and then the system should be carefully designed reviewing the regulatory environment. One of important discussions was whether or not subsidies would make the market regressive or create market distortion. From a viewpoint of the European treaty Article 87, there was an opinion that the European Commission might pay attention to several subsidy challenges in EU members in terms of the violation of the treaty, where targeted subsidies do not need the permission of the Commission.

After this session, from a concern that many transition countries tend to consider interest rate subsidy a sort of free government money and not subsidy, the definition of subsidy was reconfirmed: "a subsidy is an *incentive* provided by government to enable and persuade a certain class of producers or consumers to do something they would not otherwise do, by lowering their *opportunity cost* or otherwise increase the potential benefit of doing so" (adapted from US Congress 1969).

3. Safety and Soundness of Mortgage Markets

Well-organised regulatory and supervisory frameworks are indispensable for transition economies to achieve the maximum benefits from mortgage markets. Mortgage markets are regulated at national level but their regulations still seem to have problems of inefficiency and un-transparency. Typical information asymmetry in the region will make borrowers and investors hesitant to enter the mortgage market. Also due to the variety of mortgage products, establishing common standards of regulations for the overall mortgage market will be most challenging in the region. A proactive approach of regulation with transparency is also important. In this context, this session discussed the regulatory challenges in primary and secondary mortgage markets, addressing the role of government to activate mortgage markets in the region.

Mr. John Thompson, OECD Secretariat, raised some regulatory concerns on housing finance markets. Objectives of regulation of mortgage finance can be considered three-fold: 1) consumer protection; 2) develop primary mortgage market, effective funding techniques and capital markets; and 3) enhance systemic stability. Over-regulation can lead to fragmentation of the housing finance markets because of differences in laws and regulations covering primary consumer protection, mortgage market, protection of property, valuation standards, registration of land and mortgages, mortgage bonds and prudential rules regarding funding. In the U.S., relatively homogeneous set of laws (standardisation) has led to a unified national market.

For consumer protection, regulation should cover the following issues: information provided prior to concluding contract (APR (average percentage rate), rights of repayments including charges, process of indexation and adjustment of interest rates, etc.); measures to prevent excess indebtedness (credit

scoring, etc.); reflection periods (certain model of time to reject proposed mortgage, etc.); and notification upon transfer of mortgage.

To support primary market, legal and regulatory framework firstly should take care of property rights, which is rather serious in transition economies: e.g., title of property, especially issues in condominiums and cooperatively owned housing, where title of property has not yet to be clear after the mass privatisation; collateral issues (ability to pledge assets); and delinquency and repossession. Transparency and information should be also taken care of: e.g., land registration, valuation methods, mortgage and credit registration, privacy and confidentiality in data protection, and data on delinquencies (credit history). Other issues are reducing transaction cost, efficiency of service, and speed of approval.

For funding techniques, all deposit based funding, covered bonds and securitisation (MBS) require special techniques. Regulatory principles need to put force in neutrality among possible funding techniques and to allow funding to develop inline with market. Firstly, deposit based funding, predominant in transition economies at present, is characterised as 1) lowest cost of funds; 2) lender retains credit risk; 3) 35% risk weighting under Basel II; 4) attractive in a falling interest rate environment; 5) interest rate risk remains with bank; and 6) derivatives can reduce interest rate risk. However, a question is how long retail deposits can fund mortgages. Taking account of developing sophisticated techniques in the market, competitive rate of return will not be expected in deposit based funding, which may have to be removed. Secondly, mortgage covered bonds, one of the largest asset classes in Europe, are characterised as 1) lender retains credit risk; 2) low risk weighting under Basel II; 3) favourable treatment under UCITS directives; and 4) interest rate risk and prepayment risk transferred to investors. Preconditions for high credit standing of mortgage bonds will be strong credit analysis skills in originators and/or mortgage credit institutions, sound valuation procedures and techniques, historical data on payments (arrears and defaults), strict lending criteria, etc. Strict enforcement of eligibility criteria for mortgage bond issuance promotes strong credit procedures throughout the financial system. Thirdly, MBS is characterised as 1) assets removed from balance sheet of originating institution; 2) all risks (credit, interest rate and prepayment risks) transferred to investors; 3) capital freed to support other transactions; 4) originator earns servicing fees and excess spread; and 5) can achieve a higher credit rating than the originator. MBS can be restructured to meet investor demand through multi-class securities with multiple treanches (different credit risks and payment profiles) or deferring degrees of prepayment risks, where there exists great flexibility of MBS. Legal and regulatory problems with MBS will be in the following issues: 1) off balance sheet treatment by banking regulators; 2) compatibility of SPV with domestic legal norms; 3) legal recognition of sale of collateral; 4) legal recognition of investor claims on collateral; 5) bankruptcy remote status of SPV; and 6) taxation of transactions at various points. Hereby, two regulatory approaches can be considered: develop national legal mechanisms or go offshore for SPV.

Thus, the regulatory framework should leave banks with multiple options (deposits, mortgage bonds and MBS), emphasise primary market legislation, share risks with private sectors, involve rating agencies, and minimise dependence on subsidies and tax benefits. Regulation should allow system to evolve in response to market forces and align practices internationally.

Mr. Matej More, Ministry of Finance in Slovenia, introduced the recent progress of Slovenian mortgage market legislation. In Slovenia, mortgage as collateral is widely used in corporate finance but mortgage finance is still playing a weak role in housing finance though improving. Housing loans insured by insurance companies (classical credit insurance) are predominant in the housing finance market (almost half of the market) but have been declining recently. By contrast, mortgage lending has been growing (36% market share in 2003), especially in new bank lending (over 50% of banking housing loans in 2003). However, mortgage lending is still small in scale. The reason why mortgage

is not so popular in Slovenian housing finance market is because land registration system, foreclosure procedure and other legal environment have not been developed.

Against this backdrop, regulatory challenges in improving efficiency of primary market are effective land register system, mortgage legislation on land debt (modelled on German system), and protection of mortgage lenders (foreclosure and eviction procedures). A big progress is an information system of land register completed in 2004, which is fully computerised. 97% of paper records were converted into digital records (Dec. 2004). Thanks to this system, backlogs in registration were substantially reduced.

There is currently no secondary mortgage market in Slovenia but the government (Ministry of Finance with Central Bank) just started to consider the draft law on mortgage and communal bonds. Regulatory challenges in developing secondary mortgage market is what model is appropriate in Slovenia, where main issues are 1) mortgage bonds versus MBS, and 2) specialised banks versus universal banks. Regarding the first point, there is no exclusive choice and both mortgage bonds and MBS can co-exist, but the government finally is going ahead to mortgage bonds because of considering them simpler legal and tax infrastructure than MBS (complex and costly system of SPV). Regarding the second point, the government is heading for universal banks with a special license rather than specialised mortgage banks because specialised banks can be considered economically inefficient in relatively small Slovenian market (commercial banks do not have enough mortgage loans as cover assets, where the problems with specialised banks are standardisation of loans, transfer costs of loan portfolio, etc.).

Mrs. Daniela Grabmüllerová, Ministry for Regional Development in the Czech Republic, introduced the housing system and policy, and the recent legal developments in the Czech Republic. The Czech Republic has relatively large rental sector, which accounts for around 30% of the housing market, while most of which are still under strict renter regulations. People live in relatively small dwellings but new construction tends to go large floor space (over 100m^2). Similar to other European countries, the Czech Republic has encountered aging problem with decreasing childbirth. According to the Ministry's survey, people, particularly people above aged 65, are rather satisfied (80%) with their own housing situation but not with the government housing policy, which is mainly caused by the "heritage" of the distributional model and by a not-completed housing reform. Most of people, even wealthier people, live in cheap regulated flats and tend to keep this situation (liquidity problem of housing). Therefore, many young people are heading for the unregulated rental market, where the rent is high. At present, the Czech Republic does not have flexible housing market. There are several state subsidies on mortgage market such as interest rate and tax subsidy. A big progress is that the Czech Republic will reduce VAT on new residential house construction by 5% until 2007.

In the discussion session, it was pointed out with the Czech rental housing that regulated rents must suffer maintenance problems if the regulation had no change and it would make people's satisfaction level down. Czech regulated cheap flats are owned by municipalities (60%) and private/legal persons (40%). In the Slovak Republic, the situation has been a bit advanced: the government has tackled the reform of rent control regulations according to the suggestion of the National Council (as of Dec. 2004). Also, regarding legal frameworks of secondary mortgage markets, it was an opinion that transition economies tended to head for the existing secondary market architectures (US model or UCITS directives) to establish their own models but a critical question would be what the strategy to diversify the risks was.

4. Innovations in Mortgage Insurance

Encouraging the innovation of mortgage products is important to develop the mortgage market in transition economies. Effective mortgage products must be plain instruments from a borrower's point of view, low-risk instruments for lenders and cost-efficient instruments for borrowers, which will stimulate mortgage issuance. Mortgage insurance, which reallocates risks, can be a key product both for expanding mortgage markets and developing securitisation in the region. This session focused on mortgage insurance as an innovative product to activate mortgage markets in the region. Firstly different models of mortgage insurance in the OECD countries were overviewed and then selected transition economies discussed the mortgage insurance systems.

Dr. Mark Stephens, University of York, introduced the U.K. experience on mortgage insurance. Private mortgage insurance is a long-standing system to protect lenders from losses. Through the efforts over nine years, the system has shifted from state protection for individual borrowers to private mortgage insurance to protect borrowers. In the U.K., homeownership level has been rising (50% to 70% during 1970-2004) due to public housing privatisation and mortgage deregulation (1980s). U.K. mortgage system is traditionally retail-based and products are mostly variable rate mortgage. To protect the lender, mortgage indemnity guarantee (MIG) has been running for a few decades, which was initially a popular system; supported over 75% LTV, third party protection for lenders from losses, paid by borrowers, and commission for lenders. U.K. mortgage market is quite volatile. Big house price boom came in the 1980s and lasted till the mid 1990s, where the mortgage market severely tested the MIG (early 1990s); repossession ratio rose as mortgage arrears increased. During 1990-1993, U.K. top 5 lenders missed the market because mortgage provisions had risen but the write-offs had also risen, where MIG nicely covered the losses. Initial response of mortgage insurers was repricing by insurance cost and great loss sharing with lenders, but in the long-term, MIG was shifted to self-insurance system, more focusing on high LTV loans and increasing use of risk-based pricing.

To protect the borrower, the government has paid mortgage interest through its social assistance scheme (ISMI) since 1948. However, the scheme became expensive in the 1990s and demonstrable in effective (crowding out). Thus, the government changed its policy to encourage private insurance to protect borrowers. Mortgage payment protection insurance (MPPI) is a popular private insurance in U.K., which is a voluntary system and mostly sold by lenders (but rising sales share by intermediary). The costs have come down since mid-1990s but are still not cheap (£5/£100 of mortgage payment). Take-ups of MPPI have been rising (approx. 25% to 35% of new mortgages during 1998-2003). Popular MPPI is a full cover ASU (accident, sickness and unemployment). The ratio of claims to insurance policies in force is around 4% (3% in 2003), where the acceptance ratio is quite high (around 90%). Finally, the U.K. system can be evaluated as follows: take-up limited, no adverse selection, attitude to insurance companies important in determining take-up, limited coverage of risks, and never tested in recession.

As a representative from business practitioners, **Mr. Sacha Polverini**, Genworth Financial, discussed the mortgage insurance opportunity in emerging mortgage markets. As already mentioned, mortgage markets in transition economies have rapidly grown but still remain lots of challenges: 1) for funding issues, limited secondary market (little tapping capital market due to volatile macroeconomic conditions) and restricting banks' resources (mismatch between short-term deposits and long-term mortgage credits); 2) for production issues, limited product innovation, restricted competition and cultural aspect; 3) for loan management, lack of experience data and necessity of improving market information; and 4) for recovery issues, slow mortgage registration procedures and general reluctance to deprive people of their homes.

Empirical data shows high LTV loans cause high default risks and are more volatile when market turns. Loss frequency experience is significantly higher in recession time. Against this backdrop, mortgage insurance protects banks from borrowers' defaults on high LTV residential mortgages. By reducing risks for lenders, mortgage insurance allows earlier homeownership for borrowers. In Spain, mortgages above 80% LTV are usually supplemented with a personal guarantee from other individuals (parent supports) but the system is slowly shifting to mortgage insurance.

Public guarantee systems already exist in transition economies: Lithuania (government sponsored mortgage insurance company), Latvia (no real facilities exist but guarantee fund sponsored by the World Bank exists), Estonia (KredEX), Kazakhstan (Mortgage Guarantee Fund) and Slovenia (state insurance). Their programs, all state financed, are often a success for creating both lenders and investors confidence in the market but often much more limited especially in Western Europe (accessibility, etc.). In this context, private mortgage insurance can be a critical tool to complement public initiatives. Effective private mortgage, targeting low-income households, creates new markets through high LTV lending, which can help to standardise valuation procedures of mortgage credits. The intermediary step will be a public-private partnership. Also, effective regulatory framework on mortgage markets (i.e., recognition of mortgage insurance as an eligible credit risk mitigator for capital relief purposes) will provide right incentive for lending institutions to use sophisticated forms of unfunded credit protection such as mortgage insurance.

From the OECD countries, **Mr. Andrew Clapham**, Pangaea Consulting limited in New Zealand, discussed the innovations in mortgage insurance from a New Zealand perspective. In New Zealand, the new mortgage insurance scheme (LMI; lending mortgage insurance) just started in September 2003 with Kiwibank, relatively new bank, through government partnership. Against this backdrop, the current mortgage environment is describes as follows: 1) declining homeownership level (68%); 2) increasing house prices faster than household incomes; 3) deregulated private mortgage market; 4) competition for lower priced housing (targeting first-time buyers); 5) deposit requirements of 5-20% depending on the location; and 6) mortgage insurers strongly influence credit criteria approved by banks (80% LTV, etc.). The government has backed out of large scale direct state lending. Its role focuses on leveraging the private mortgage market and facilitating homeownership for state tenants paying market related rents.

LMI targets first home buyers on modest incomes, including those unable to meet standard deposit requirements, state tenants paying market related rents and multi-borrower groups (extended families), where maximum income caps are $55k for single and joint borrower households and $100k for multi-borrower households. LMI runs as a two-year pilot. The government subsidises LMI premium (2% of loan amounts). In the credit criteria, there are two-tier deposit requirements: nil deposit required for properties up to $150k and 5% deposit required for properties above $150k, where there are no regional variances. LMI purchasers can enjoy pre-purchase advice (booklet) and post-purchase support (close account monitoring, regular client contact, etc.). The demand of LMI is quite high. Through this new scheme, over 500 families have moved into their new homes. At present, the LMI scheme is working from the following point of views: 1) clearly responding to a high level of interest; 2) broad target group is being reached (but state-tenants and multi-income households still open to question); 3) one-time government subsidy is most cost effective than interest rate subsidies; and 4) origination costs were higher initially but are easing down now. System flexibility and borrower education will be keys to develop the mortgage insurance system in New Zealand.

As a representative from transition economies having a mortgage insurance system, **Ms. Maive Rute**, KredEx in Estonia, introduced the Estonian mortgage insurance scheme. In Estonia, housing finance market has been significantly increasing over the last three years (50-55% annual growth). The housing debt to GDP is now around 18%, which is one of countries with the highest housing debts in

transition economies. In this situation, mortgage insurance business is moderately growing. KredEx is a self-sustaining guarantee fund established by the government (Ministry of Economic Affairs and Communication) in 2000; i.e., a public guarantee scheme, which business consists of three guarantee schemes: loan/leasing guarantees for SMEs, export guarantees, and mortgage insurance. Equities for housing guarantee schemes amount to EUR 8 million, which is one fifth or sixth of total housing loans outstanding in Estonia. Recently, a private mortgage insurer has entered into the Estonian market through the partnership with a big commercial bank (Hansabank), which products are similar to the KredEx's.

The important difference from private mortgage insurance is that KredEx strictly limits the target markets from a risk point of view; i.e., three core targets: 1) young family at least with one child under 16 year-old, 2) young specialist who is not over 35 year-old (30 year-old from 1 May 2005) and has higher or special vocational education and a valid employment or service contract; and 3) tenant living in a restituted building who used the dwelling at the moment of restitution of the dwelling (small share of the business). Mortgage insurance in KredEx covers up to 24% of the loan collateral value but not over EEK 300,000 (EUR 19,250). The insurance coverage expires when the loan balance amounts to 66% of the collateral value. First down payment requires 10% of the collateral value. The guarantee fee is 3% of the total amount of the insurance up-front. In Estonia, there are no obligations to use mortgage insurance on mortgage lending. The share of insured mortgage loans has been coming down recently (15% in 2004) because of flexible loan products by banks. Having said that, KredEx has made good performance so far, which paid out only three loans out of over 12,000 insured loans until now; i.e., loss ratio is less than 0.1%. As a product innovation, KredEx has currently tackled loan guarantee for multi-apartment buildings, where KredEx guarantees 75% of the loan balance proportionally until the end of the loan period, targeting apartment associations, cooperatives and community of apartment owners for the purpose of renovation. KredEx can take over loan payments up to 12 months if necessary. The guarantee fee is 1.2-1.7% per annum on the balance of the guarantee.

Mr. Valdis Zakis, Housing Agency in Latvia, discussed some thoughts about unique insurance scheme from an infrastructure point of view; energy performance. In Latvia, two third of households live in multi-family apartments constructed 24 years before or more. Housing affordability is nothing changed for low-income households over past years. In addition, their incentives to move into new houses tend to be low. The problem is the low accessibility to housing finance. The government planned to launch the Housing Guarantee Fund in 2002 by introducing the capital of EUR 4.2 million but the scheme has yet to be realised. Instead, the government priority has been shifted to the establishment of Social Housing Guarantee Funds (2004) but there is no official information. Against this backdrop, an energy performance guarantee scheme can be a possibility of improving housing affordability and housing finance accessibility for households, because many of housing stocks involve energy problems (e.g., heating problem). In this idea, energy audit can be a financial guarantee tool.

After this session, several questions concentrated on the Estonian public guarantee scheme. In Estonia, a private mortgage insurer is now heading for the market to skim up better borrowers. Against a question if this situation reflected the pricing in KredEx, an answer was no competition with private sector because of its state entity status. Also, there was a discussion on the definition of subsidy again; operations of KredEx are regarded as subsidies or not. For a question about the Estonian recovery scheme from delinquent borrowers, it was explained that a well-organised foreclosure process and increasing collateral values would effectively cover the losses. Although KredEx paid out only three cases so far, the system has never been tested in the recession time, it was added.

5. Development of Different Secondary Mortgage Markets and Instruments

Capital markets provide issuers of mortgage related securities with opportunities to raise funds for housing finance and may develop the secondary mortgage market. Different countries have developed various funding instruments such as mortgage bonds, contract savings schemes and mortgage-backed securities (MBS), which reflect their historical and cultural backgrounds. Mortgage instruments such as mortgage bonds and MBS also provide investors with opportunities to diversify their investment portfolios. As investors often seek low-risk investments, issuers of mortgage related securities are required to manage potential risks involved in the products to secure adequate funding for housing. Therefore, well-controlled risk management is a key factor to develop the secondary mortgage market. Considering capital market funding for housing, institutional investors such as pension funds and insurance companies will particularly contribute to growing mortgage markets, improving liquidity and developing mortgage market infrastructure. In this context, the discussion focused on three issues: 1) comparison of different mortgage funding instruments in the region; 2) risk management techniques and obstacles for transition economies to implement them; and 3) role of institutional investors to vitalise mortgage markets.

Different Mortgage Funding Instruments

Mr. Tim Lassen, Association of German Mortgage Banks, introduced the recent development of covered bond markets and systems in Europe. Covered bond market is the largest non-public securities market in the EU capital market, which issuance volume amounted to EUR 1,554 billion in 2003. Among new EU member states, the Czech Republic, Hungary, Latvia, Poland and the Slovak Republic have entered into the European covered bond market. Among them, the Czech Republic and Hungary have already reached a significant amount of outstanding covered bonds. Germany accounts for almost 70% of the European market but its market share has been decreasing recently. By contrast, markets in other countries have been sharply growing. European covered bonds are divided into two types: mortgage covered bonds (high market share in Denmark and Germany; over 30% respectively in 2003) and public covered bonds (dominant status in Germany; 92% market share in 2003). Outstanding volume in German *Phandbrief* is larger than any other Euroland government bonds (including German government bonds). Funding through mortgage bonds is a dominant funding instrument in Denmark (100%), while only 19% of funding relies on mortgage bonds and the remaining does on banking system in Germany (what is connected to specialities of the German banking system, especially the large amount of public sector banks). In Central Europe, Hungary has recorded high volume of covered bonds issuance (69 issues as of Sept. 2004) and outstanding (over EUR 3,700 million in Sept. 2004), which is backed by the banking sector commitments to use covered bond as a funding instrument, a good solution for mortgage transfer from originator to mortgage bank, and a flexible supervision. Those factors are assisted by the state subsidy policy. By contrast, Polish market is very small in scale (16 issues, EUR 240 million in Sept. 2004). One of Polish mortgage banks has decided to no longer issue mortgage loans and instead concentrates on commercial lending. There are several reasons in this background; e.g., difficulties in transferring mortgages and the absence of appropriate state support. Furthermore, Polish commercial banks have currently enough liquidity mainly from deposits. The risk of maturity mismatch has yet to be sufficiently addressed. The ratio of covered bonds outstanding to GDP is quite high in Denmark (123% in 2003), but those in five new EU members are quite small (below 6%) though sharply growing. In the background why covered bonds, along with economic and risk management reasons, are so attractive as a funding or capital market instrument in Europe, there are regulatory advantages in the EU laws such as Article 22 (4) of UCITS directive, under which covered bonds are positively used as a privileged investment instrument in Europe; i.e., privileges with investment funds, life insurance, capital adequacy, etc. Also, under Article 63 (2) consolidated banking directive in EU, risk weighting of covered bonds is

only 10% (instead of 20%) of normal banking loans in most of European countries, which results in high security of European covered bonds.

Currently, 22 European countries (19 EU members plus 3 transition economies; Bulgaria, Romania and Russia) have their own covered bond legislation. Concrete legislation is under preparation in 4 countries (Belgium, Estonia, Slovenia and Ukraine). There are some differences in legislation of respective countries; 1) the way to evaluate real estate: 10 countries (e.g., Austria, France and Germany) make use of long-term mortgage lending value while 12 countries (e.g., Spain) use market value; 2) LTV limit for covered bonds: 60% LTV limit in 8 countries (e.g., Hungary and Poland), 70% in 3 countries (the Czech Republic, Russia and the Slovak Republic) and several LTVs in 11 countries (e.g., Denmark, France, Latvia, Lithuania); and 3) specialist bank principle (specialised mortgage banks): adopted in 12 countries (e.g., Hungary and Poland).

There are four types of covered bond issuers: 1) specialised funding vehicle as a covered bond issuer (e.g., SPV), namely, French model; 2) specialised mortgage banks without/with non-eligible business: Denmark, Germany, Hungary, Poland, etc.; 3) universal banks with qualified covered bond license (qualified requirements for issuing covered bonds such as special risk management measures): Latvia, etc. (Slovenia is drafting a law. In Germany, the new Covered Bond Act is adopted by the parliament and will come into force on 19 July 2005); and 4) universal banks without license or with mandatory license, but without requirements to obtain the license: the Czech Republic, the Slovak Republic, etc. Hereby, there are several discussions of specialisation of issuing covered bonds in terms of supervision (efficiency, LTV limits, security through institutional barriers or over-collateralisation), risk management (responsibility for risk and asset/liabilities management, own risk awareness of the issuer, freedom of the issuer which assets he wants to take into the cover pool, generating of own business or being a funding vehicle for the banking group), priority issues (relation between covered bond creditors and unsecured creditors, namely, “ring fencing”), market sustainability (diversification of products, avoidance of opportunistic covered bond issues, and a commitment of the market participants to create and develop a covered bond market), and profitability (costs of creating a specialised issuer and the operation). A big issue to be tackled in every country is the segregation and bankruptcy remoteness of cover assets of covered bonds from a security point of view.

As a representative from CIS countries, **Mr. Mars Aldashov**, Financial Supervision Authority of Kazakhstan, explained the mortgage lending system and the secondary market funding scheme in Kazakhstan. Kazakhstan has experienced good economic growth recently. Inflation rates are relatively stable and income level is also growing. Mortgage lending system has been well developed since 2000. As a new financial mechanism, contract savings scheme modelled on *Bausparkassen* system is currently under development. In December 2000, the National Bank of Kazakhstan established a special financial institution, Kazakhstan Mortgage Company (KMC), modelled on *Fannie Mae* in the U.S. and *Cagamas Berhad* in Malaysia. KMC purchased mortgage loans (all domestic currency loans) from partner banks with its agreements and then issues mortgage bonds for funding. The administration of mortgages remains in banks. The partner banks are obliged to repurchase any defaulted loans and loans inconsistent with KMC standards (i.e., banks hold credit risk). During 2001-2004, KMC mortgage portfolio has been sharply growing (KZT 2.6 to 63.2 billion). Interest rates have come down (28% to 13%). Loan terms have been extended (3 to 20 years). LTV has increased (50% to 85%). Banks tend to use KMC mortgage lending standard even in case of having their own standards because of 15% risk weight for capital adequacy according to KMC standard (100% risk weight for others). In KMC program, borrowers can enjoy both life and property insurance.

KMC bonds have been significantly developed in the secondary mortgage market in Kazakhstan. KMC bonds are covered by mortgage loans pool. 6 bonds have been issued since 2002. Ordinary issuance volume is KZT 5.0 billion. Fixed margin over inflation is typically 0.39%, where coupon rate is around 8%. Main bond holders are pension funds (56%). KMC decided to issue simple mortgage bonds (tenge denominated) because of the difficulty in determining real default rate and real price of path through bonds in emerging market. Currently, a law on securitisation (SPV, bankruptcy remoteness, credit enhancement, etc.) is drafting in Kazakhstan. In 2007, however, market conditions will be dramatically changed because of starting negotiation of WTO accession and amending supervisory legislation compatible with EU directives (UCITS). Main shareholder will be also changed from the National Bank of Kazakhstan to the Ministry of Finance.

Risk Management Techniques

Mr. Henrik Andersen, Nykredit in Denmark, discussed the risk management techniques in a Danish mortgage bank, referring to the Danish mortgage bond market and the legislation. Danish mortgage bond market is one of the largest markets in Europe, where Nykredit/Totalkredit accounted for 41% market share. There are no foreign mortgage bond issuers. In Denmark, loan portfolio is quite diversified; retail housing accounted for 58% of total mortgage loans and rental building did for 18% (2004). Since 1997, loan loss ratio has been stably quite low (total annual loan loss ratio of Nykredit, Realkredit and Totalkredit has been lower than 0.07% of bond debt outstanding).

Danish mortgage credit legislation is characterised as follows: 1) exclusive rights: only authorised mortgage credit institutions can issue mortgage bonds; 2) elimination of financial risks through pass-through securities due to the "balance principle"; 3) special restrictive requirements on property valuation (high quality of cover assets); 4) bankruptcy remoteness: cover assets for bonds (collateral pools) are segregated in special capital centres; 5) capital adequacy ratio: minimum 8% of risk weighted assets (typically, 50% risk weight for retail mortgages and 100% risk weight for commercial mortgages); 6) a forced sale is executed within a year from the first arrears are recorded; and 7) supervision by the Danish FSA.

The Danish "balance principle" strictly regulates the mortgage lending and bond markets in terms of risk management, which is characterised as 1) all bonds are covered by mortgages; 2) cash flow matching of mortgages and bonds (calculating all liquidity differences daily); 3) all unmanageable financial risks are prohibited (e.g., not allowed to issue callable loans based on non-callable bonds); 4) detailed risk control rules (liquidity risk, interest rate risk, currency risk, etc.); and 5) the individual loan is linked to specific bonds (borrowers must compensate the mortgage bank in case of prepayments.).

In Nykredit's risk management, for example, "one-to-one balance" for callable fixed rate and adjustable rate loans (i.e., issued bonds must be equal to mortgages) is a key policy to avoid mismatch between bonds and loans. It is easy to manage risks. Nykredit has a policy of the 2% rule for cash prepayments of non-callable loans but has not used it so far. As credit rating tools, credit scoring models in the retail customers were implemented in 2000. Basel-confirm internal ratings have been also introduced in the commercial (2003) and agricultural (2004) customers. Currently, Nykredit has been working hard to ensure Basel compliance (Basel II) in credit models since 2003.

Role of Institutional Investors to Vitalise Mortgage Markets

Lastly, **Mr. Stephen Lumpkin**, OECD Secretariat, discussed the role of institutional investors in the housing finance market. Most institutional investors exist inside a defined institutional and legal framework, which tends to vary across different investor types by factors affecting their solvency, the

types of assets they manage, etc. Many institutional investors operate under fiduciary mandates, though the nature of the mandates varies. Special tax regimes also influence the operation of institutional investors. The main objective for an institutional investor is typically to earn an adequate return on funds invested and to maintain a comfortable surplus of assets beyond liabilities. Real estate can play such a role. However, in order for this asset class to do so requires a considerable amount of infrastructure. To establish an efficient market infrastructure of housing finance, it is necessary to create appropriate legal and regulatory environment in which institutional investors can operate. The experience from developed economies shows that once this is done, institutional investors, by investing in assets, contribute to the growth and development of capital markets including mortgage markets.

After this session, there was an opinion that European covered bond legislation seemed to provide a favourable treatment only for big banks, not for small banks and other credit institutions. Against this, it was explained that covered bond was not an instrument only for big banks, for example, small municipal savings banks also issued covered bonds on an equal footing in Germany. Covered bond issuers do not always get high ratings (AAA/Aaa) of securities, which depends on countries' conditions, where covered bonds are secured by legal framework and ratings of bonds are only the opinion of rating agencies, it was added.

Conclusion

The conference was successfully concluded and very much appreciated by all participants from viewpoints of open discussions covering the wide range of issues of primary and secondary mortgage markets in the region. Mr. Gjede's excellent chairmanship should be noted for the success of this conference.

FOURTH OECD WORKSHOP ON HOUSING FINANCE IN TRANSITION ECONOMIES

14-15 December 2004, Paris

AGENDA

Introductory Session: Opening Remarks

Welcome remarks by **Mr. William Witherell**, Director of the Directorate for Financial and Enterprise Affairs, OECD
Introductory remarks by **Mr. Torben Gjede**, Director General of the Association of Danish Mortgage Banks

Session 1: Overview of Mortgage Markets in the Region

- Impact on mortgage markets as a result that ten countries joined the EU
- EC efforts to harmonise a single mortgage market in Europe/ lessons from EU countries
- Progress of mortgage markets in other transition economies

- **Mr. Shigehiro Shinozaki**, OECD Secretariat
- **Mrs. Annik Lambert**, Deputy Secretary General, European Mortgage Federation
- **Mr. Jacek Laszek**, Advisor to the President, National Bank of Poland
- **Ms. Harsha Shewaram**, Internal Market DG, European Commission
- **Mr. Mladen Mirko Tepus**, Croatian National Bank

Session 2: Effective Housing Finance System for the Low-Income Market

- Review of housing finance availability for low-income households in the region
- Effective housing finance products for the low-income segment
- Government subsidies for housing

Part A: Housing Finance Availability for Low-Income Households

- **Mr. Loic Chiquier**, Lead Housing Finance Officer, World Bank
- **Dr. Friedemann Roy**, European Federation of Building Societies, Germany
- **Mr. Alexander Kopeikin**, Institute for Urban Economics, Russia

Part B: Government Subsidies for Housing

- **Drs. Marja Hoek-Smit**, Wharton School, University of Pennsylvania, United States
- **Mr. Achim Duebel**, Financial Services & Policy Consulting, Germany
- **Mr. Andriy Kyiak**, Banking Sector Development Division, Ukraine National Bank

Session 3: Safety and Soundness of Mortgage Markets

- ➢ Regulatory challenges in primary and secondary mortgage markets in the region
- ➢ Supervisory framework consistent with the development of primary and secondary mortgage markets

- **Mr. John Thompson**, OECD Secretariat
- **Mr. Matej More**, State Under Secretary, Ministry of Finance, Slovenia
- **Mrs. Daniela Grabmullerova**, Director of Housing Policy Department, Ministry of Regional Development, Czech Republic

Session 4: Innovations in Mortgage Insurance

- ➢ Different models of mortgage insurance
- ➢ Mortgage insurance in the region: a case study discussion

- **Dr. Mark Stephens**, Assistant Director, Centre for Housing Policy, University of York, United Kingdom
- **Mr. Sacha Polverini**, Head of European Regulatory Affairs, Genworth Financial, Belgium
- **Mr. Andrew Clapham**, Director, Pangaea Consulting Ltd., New Zealand
- **Ms. Maive Rute**, CEO, Credit and Export Guarantee Fund KredEx, Estonia
- **Mr. Valdis Zakís**, Director of the Housing Development Department, Housing Agency, Latvia

Session 5: Development of Different Secondary Mortgage Markets and Instruments

- ➢ Comparison of different mortgage funding instruments in the region
- ➢ Risk management techniques and the obstacles to implementing them in funding markets
- ➢ Role of institutional investors

- **Mr. Tim Lassen**, Association of German Mortgage Banks (comparison of funding instruments in the region)
- **Mr. Mars Aldashov**, Member of Board of Directors, Kazakhstan Mortgage Company
- **Mr. Henrik Andersen**, Head of Operations, Group Treasury, Nykredit, Denmark (risk management techniques)
- **Mr. Stephen Lumpkin**, OECD Secretariat (role of institutional investors)

Concluding Session

- ➢ Summary of the discussions by the chairman
- ➢ Closing remarks

TABLE OF CONTENTS

Part I. **A COMPARATIVE ASSESSMENT OF HOUSING FINANCE MARKETS IN TRANSITION ECONOMIES**
by Shigehiro Shinozaki ... 7

Introduction ... 8
Methodology ... 8
1. Housing Markets ... 8
   1-1. Demand of Housing ... 8
   1-2. Supply of Housing ... 13
   1-3. Country Assessments ... 14
2. Housing Finance Markets ... 17
   2-1. Primary (Lending) Markets ... 17
   2-2. Secondary (Funding) Markets ... 26
   2-3. Country Assessments ... 33
3. Regulation and Housing Policy ... 35
   3-1. Regulatory Structure ... 35
   3-2. Housing Policy ... 40
   3-3. Country Assessments ... 44
4. Aggregate Results and Lessons ... 46
   4-1. Dynamics on Housing Finance Markets ... 46
   4-2. SWOT Analysis ... 48
   4-3. Lessons ... 53
5. Mortgage Insurance ... 55
   5-1. System and Benefits ... 55
   5-2. Mortgage Insurance Markets in Transition Economies ... 57
Conclusion ... 61

References ... 63

Annex 1. General Indicators ... 65
Annex 2. Findings from Market Survey on Housing Finance in Transition Economies ... 70
1. Primary (Lending) Market ... 70
   (1) Lender and Borrower Structure ... 70
   (2) Major Lenders ... 71
   (3) Typical Loan Products ... 72
   (4) Loan Conditions ... 73
   (5) Housing Loans Outstanding ... 74
   (6) Mortgage Insurance ... 76
   (7) Contract Savings Schemes (CSS) ... 77
2. Secondary (Funding) Market ... 78
   (1) Funding Instruments ... 78
   (2) Mortgage Bonds ... 78
3. Government Support (Government Subsidies) ... 80
4. Regulations (Legal Framework) ... 81

Part II **HOUSING FINANCE MARKETS IN SELECTED TRANSITION ECONOMIES** 83

Chapter 1. HOUSING FINANCE IN POLAND
by Karol Skiba 85

Chapter 2. HOUSING FINANCE IN HUNGARY
by András Bethlendi and Gergely Kiss 103

Chapter 3. HOUSING FINANCE IN CZECH REPUBLIC
by Daniela Grabmüllerová 117

Chapter 4. HOUSING FINANCE IN SLOVAK REPUBLIC
by Dana Rigaszova 141

Chapter 5. HOUSING FINANCE IN LITHUANIA 155

Chapter 6. HOUSING FINANCE IN LATVIA
by Ilze Osa 185

Chapter 7. HOUSING FINANCE IN ESTONIA
by Jana Kask, Tarmo Klettenberg, Lembit Olev 209

Chapter 8. HOUSING FINANCE IN SLOVENIA
by Barbara Staric-Strajnar 223

Chapter 9. HOUSING FINANCE IN CROATIA
by Mladen Mirko Tepus 237

Chapter 10. HOUSING FINANCE IN ROMANIA
by Diana Popescu, Ion Bejan, Mihaela Kalogerakos 263

Chapter 11. HOUSING FINANCE IN UKRAINE
by Oleksiy Pylypets, Pavlo Matiyash 269

Chapter 12. DEVELOPMENT OF MORTGAGE SYSTEM IN KAZAKHSTAN
by Anuar Karpykov 281

Annex A. SUMMARY OF THE MEETING 293

Introduction 293
1. Overview of Mortgage Markets in Transition Economies 293
2. Effective Housing Finance Systems for the Low-Income Market 297
3. Safety and Soundness of Mortgage Markets 302
4. Innovations in Mortgage Insurance 305
5. Development of Different Secondary Mortgage Markets and Instruments 308
Conclusion 311

Agenda 312

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