Housing Finance Markets in Transition Economies

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FOREWORD

The year 2004 was notable for transition economies, in particular as ten of them finally joined the European Union. Their capital market and banking sector reforms have been proceeding at different speeds and scales. In comparison, however, their housing finance markets are typically small in scale and under developed, though it is generally recognised that fostering housing finance markets contributes to economic development and brings social benefits to the public. Taking account of the unfavourable environment for households in terms of income level, house price and loan interest rates in the region, enhancing the access to housing finance for low- and middle-income households is a key to developing their housing finance markets. Particularly mortgage lending that makes use of the property as collateral is a very important method of housing finance in terms of risk management in the region.

In response to the interests of transition economies, the OECD has provided a forum for relevant policy makers, representatives of private sectors and other experts to exchange information and experiences in the field of housing finance since 1996. In this framework, the Workshop on Housing Finance in Transition Economies was held at the OECD headquarters in Paris on 14-15 December 2004, which was organised by the Outreach Unit for Financial Sector Reform, the OECD Directorate for Financial and Enterprise Affairs, under the aegis of the Committee on Financial Markets and the Centre for Co-operation with Non-Members. The Workshop was sponsored by the Government of Japan.

This publication was prepared by Mr. Shigehiro Shinozaki, Administrator of the Directorate for Financial and Enterprise Affairs, together with policy makers and experts from selected transition economies including Croatia, the Czech Republic, Estonia, Hungary, Kazakhstan, Lithuania, Latvia, Poland, Romania, the Slovak Republic, Slovenia and Ukraine. This volume consists of a comparative study on housing finance markets in transition economies based on the market survey in 2004, country reports prepared for the Workshop in December 2004, and the summary of critical discussions in the Workshop. All papers were updated as of April 2005. The views expressed in this publication are those of individual authors and do not necessarily reflect those of the OECD or the governments of non-member countries.

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Part I

A COMPARATIVE ASSESSMENT OF HOUSING FINANCE MARKETS IN TRANSITION ECONOMIES

by

Shigehiro Shinozaki*

In transition economies, mortgage lending is very small in scale and deposit based lending is still dominant in most of countries. Against this backdrop, mortgage lending has been growing recently in the region and some of the countries have sharply developed their mortgage markets with the securitisation scheme of mortgage covered bonds. However, their funding methods for housing finance still tend to rely on short-term deposits. In addition, the government subsidy applied to housing finance tends to be unfocused in some programs, which may impede the development of primary and secondary mortgage markets in the region. Although the government spending for housing purpose has not so much bloated the national budget at this moment, their subsidy programs seem not to be cost-effective because of little targeted beneficiaries and little demand. Those programs also may impede active competition in the market. In accordance with EU directives, the basic regulatory infrastructure on mortgage market is relatively well established particularly in countries that joined the EU in May 2004. However, it seems that the enforcement level has lagged behind the advanced European countries in the compliance with international standards on financial regulations.

Taking into consideration the current market condition of housing finance in transition economies, it may be necessary for policy makers to reform existing government support measures for housing in order to vitalise their economies. In addition to cash flow guarantee schemes, the government may consider making use of mortgage default insurance schemes in order to enhance housing finance affordability for low- and middle-income households. In parallel with that, the private mortgage insurance can be a promising business in the region, which would enable low- and middle-income households to take loans for home purchases with low down payments. The establishment of private mortgage insurance schemes to accompany government schemes will be important to help vitalise housing finance markets in the region, but it will take some time given the limited experience with mortgage insurance in both the public and private sectors.

In short, the best approach towards a well functioning housing finance market in transition economies is to establish a risk-based mortgage lending system supported by a securitisation scheme, targeted to low-and middle-income households, with the removal of cost-ineffective subsidy schemes and deposit based lending.

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Introduction

The objective of this paper is three-fold: 1) investigate current conditions of housing and housing finance markets in transition economies; 2) assess their market potential compared to one another and to the advanced EU countries (EU15 countries); and 3) provide some thoughts for policy makers and for entrepreneurs based on lessons from this research. To this end, study countries are selected from countries targeted in the OECD Market Survey, which are classified into three geographical groups for convenience' sake: 1) Central-Eastern European countries and Baltic States (new EU member states, *Group 1*): the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia; 2) South-Eastern European countries (EU candidate countries, *Group 2*): Croatia and Romania; and 3) Commonwealth Independent States (CIS, *Group 3*): Kazakhstan and Ukraine.

This paper consists of five sections. The first section analyses current housing markets in the study countries to assess the supply and demand potential of housing markets. The second section investigates current conditions of housing finance markets in the region to examine the performance of both primary (lending) and secondary (funding) markets. The third section analyses the regulatory and supervisory framework in both primary and secondary markets and the national housing policy (e.g. government subsidy) to identify the legal infrastructure and the role of government. The fourth section assesses the overall performance of housing finance in transition economies based on aggregate results gleaned from foregoing chapters and provides lessons from this study. Then the final section touches upon the mortgage default insurance markets in the region and discusses the potential for the mortgage insurance business in transition economies.

Methodology

Because of the lack of comprehensive statistics on housing finance, much of the necessary data was collected from a market survey and questionnaire specially elaborated to assess the performance of housing finance markets and systems in study countries. The survey data were supplemented by the most recently available published statistics. The study field consists of three major groups and six sub-categories: 1) housing markets: a) housing demand and b) housing supply; 2) housing finance markets: a) primary market and b) secondary market; and 3) role of the government: a) regulatory structure and b) housing policy. The transition economies are compared with the advanced EU countries (EU15) as a benchmark against which to assess the performance in each study country, which are scored and translated into a performance matrix in respective groups. Then, the dynamics of housing finance markets are explored via the use of spider charts, which consolidate the results of performance matrices, with the SWOT (strength, weakness, opportunity and threat) analysis. The detailed methodology is explained in respective chapters.

1. Housing Markets

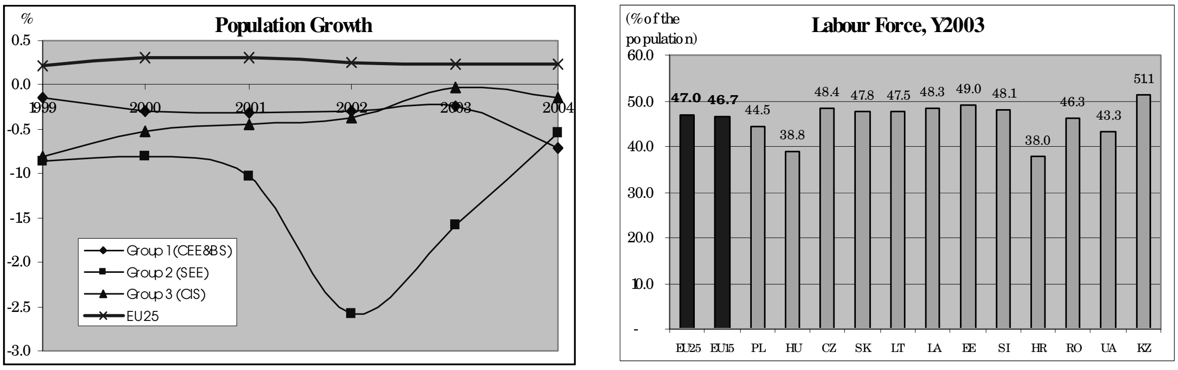
From the collected data, six major trends concerning housing markets can be identified in transition economies: 1) new demand potential given the limited growth of the population; 2) small but growing economies; 3) low housing affordability; 4) high level of homeownership but housing shortage; 5) low quality of housing; and 6) small-scale housing supply not targeting typical households. The next sections present the evaluation of housing markets in the region.

1-1. Demand of Housing

Negative population growth will hold back new demand for housing, but a relatively large amount of working age people within the population may constitute potential new demand.

Households are obviously an essential element to vitalise the housing market. Population growth, particularly the increase in the working age population, usually creates additional demand for housing. Central-Eastern European countries and Baltic States, as new EU members, account for over 16% of the total EU population at present. As seen in Figure 1, although aggregate population growth in the EU area is around 0.2%, that in study countries has shown almost zero or negative growth. This means that the potential new demand for housing from population growth alone simply is not to be expected. According to national standards in respective countries, however, roughly 48% of the population are regarded as potential labour force (working age population) in most of the countries, which is on par with the EU15 level (47%). Potential demand for housing can be created from this segment of the population.

Figure 1: Population and Labour Force

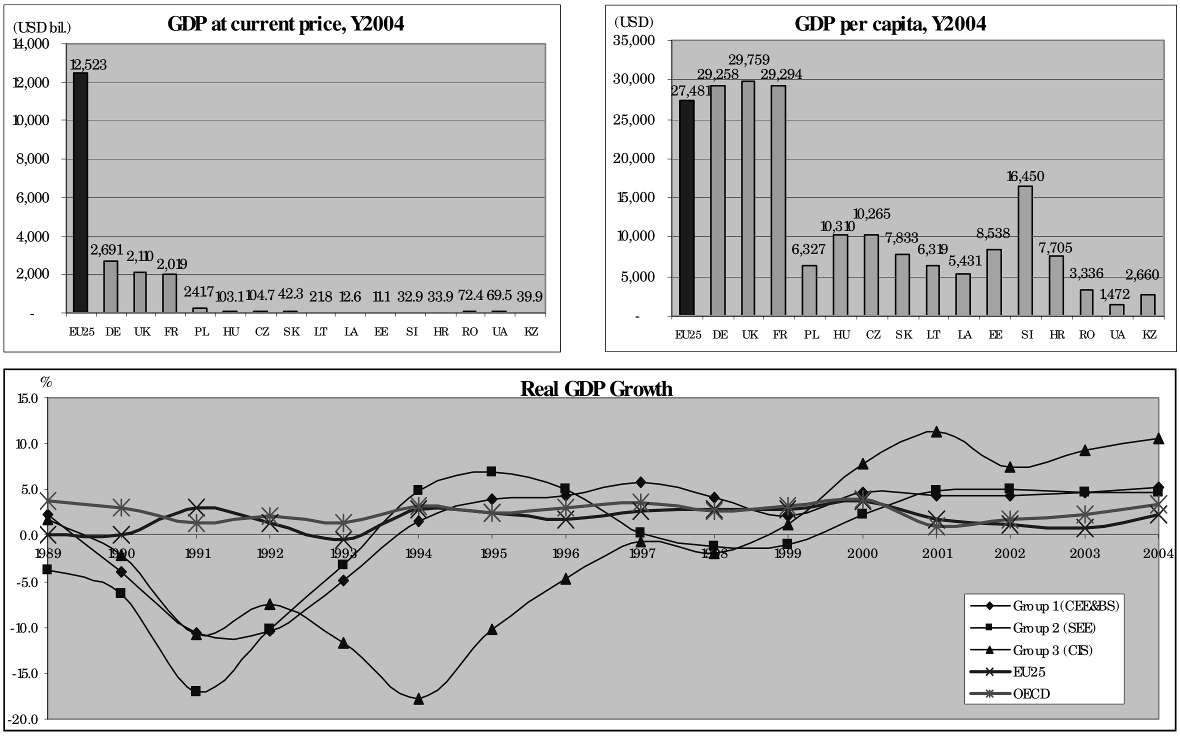


(Source) The Economist Intelligence Unit

GDP is small in scale in the region, but economic conditions have been gradually improved.

Gross domestic product (GDP) in study countries is still small in scale as compared to the advanced EU countries. No countries in the region exceed the EU average of GDP per head (with most less than half the EU average except for Slovenia). However, their real GDP growth (estimated at 4-12% growth in 2004) has been above both the estimated EU average (2.3% in 2004) and the OECD average growth (3.4% in 2004). All study countries faced severely negative economic shocks immediately after achieving their independence but their economic performance gradually recovered by late 1990s. Since then, their domestic economies have been growing at different speeds. Particularly, as countries in Group 1 and 2 were required to clear several economic criteria for accession to the EU, their economic conditions would be expected to improve further. The positive economic growth in the region will be a driving force for stimulating household consumption including of housing.

Figure 2: Gross Domestic Product



(Source) EBRD Transition Report 2003, OECD Economic Outlook VOL. 2004/1 No.75, The Economist Intelligence Unit

Inflation rates have moderately diminished and wage levels have been improved, but high prices of housing and still low incomes have been limiting housing affordability in the region.

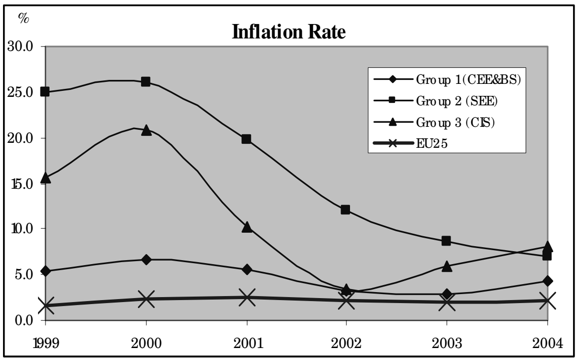
High inflation makes households hesitant to invest in goods and services, even more so for home-purchase given its expensiveness. Consumer price inflation has moderately diminished from double digit rates to single digits (estimated at roughly 1-9% in 2004) in study countries except for Romania (estimated at 12%). However, inflation rates in the region have still remained above the EU level of 2% except for Lithuania (1%) and Croatia (2%). Furthermore, house price inflation is much higher than for any other goods (e.g. foods and alcohols) and services (e.g. transport and recreation) in study countries (in particular, in the Slovak Republic and Kazakhstan, which recorded rates over 22% in 2003), and rates are also beyond the EU15 average (2.6% in 2003) in most of the countries.

In addition, people in the region have unfortunately experienced a rather low income level, which also tends to impede active household consumption. Although the rate of increase in monthly average wages in study countries has been above EU15 average growth, they are still less than half of the EU15 level (mostly less than a quarter). Also, most of study countries, except for Group 3, still face high unemployment rates, particularly in Poland, Slovak Republic, Slovenia, and Croatia (11-20%) as compared to the EU average (estimated at 9.4% in 2004).

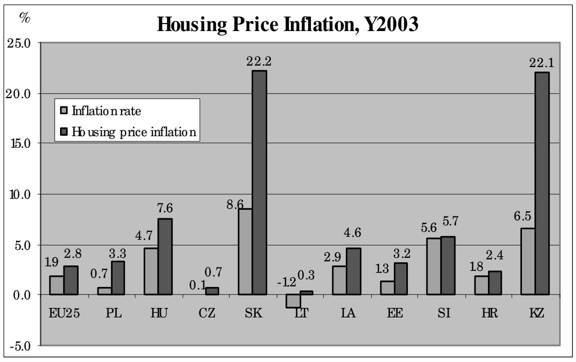
Even so, housing related expenditures (new purchase, maintenance, etc.) in the region account for roughly 20% of the total household consumption, which is equivalent to the EU15 level (21%).

Taking account of those conditions, there will still be many more households in transition economies who do not have access to the housing market compared to those in the advanced EU countries, despite the fact that there exists an untapped potential demand for housing.

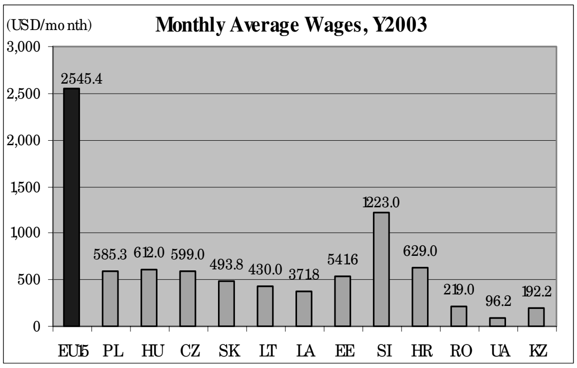
Figure 3: Inflation, Unemployment and Earnings



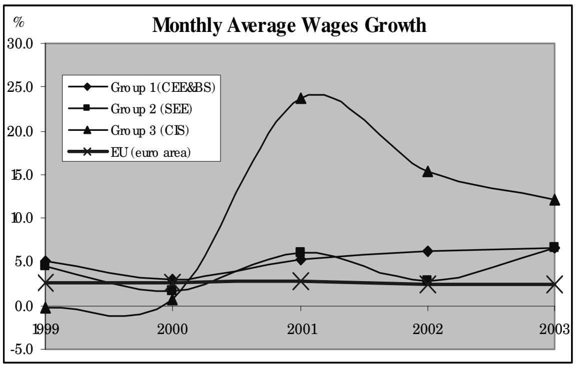
(Source) The Economist Intelligence Unit



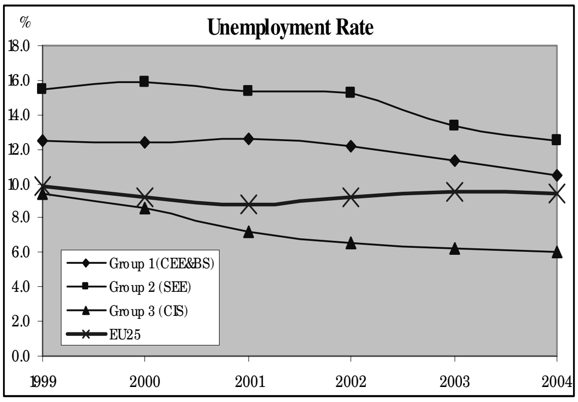
(Source) Eurostat, Country Notes on OECD Housing Finance Workshop 2004



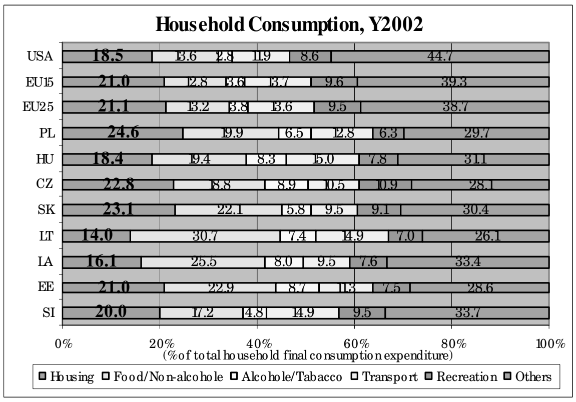
(Source) The Economist Intelligence Unit



(Source) The Economist Intelligence Unit



(Source) The Economist Intelligence Unit, EBRD Transition Report 2003

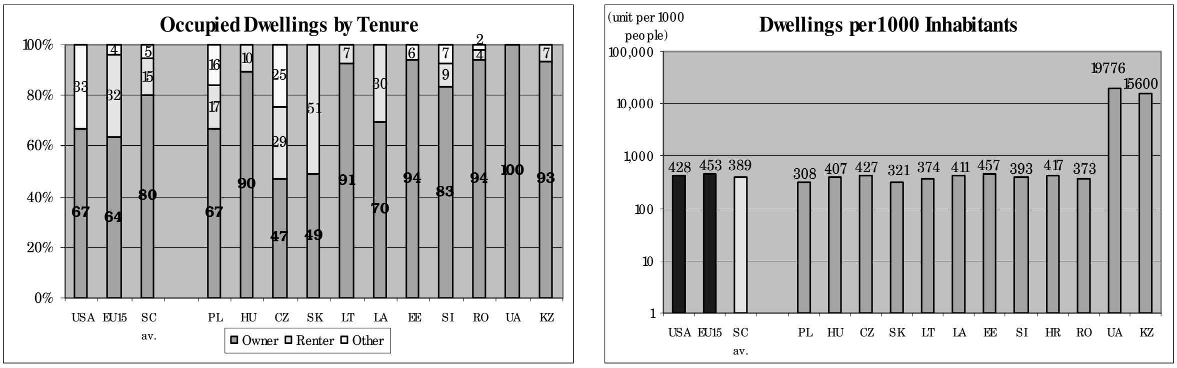


(Source) Eurostat ; CZ, LI & LA : data in 2000

The high level of homeownership has been achieved while most of countries are under the housing shortage.

In the former socialist regimes, the government used to provide housing to the public according to the centrally planned economy. Since gaining independence (early 1990s), most of the study countries have actively encouraged homeownership by means of mass housing privatisation and the introduction of several subsidy programs for housing, which were expected to spur the transition to a market economy. As a result, most study countries have achieved high levels of homeownership (average of 80% of total occupied dwellings) in comparison with EU15 (approx. 64%) and the United States (approx. 67%), although the Czech Republic and the Slovak Republic are still below the average with homeownership rates of about 50%. In contrast with this situation, as seen in the number of dwellings per 1000 inhabitants, housing stocks in study countries suggest there is a housing shortage (study countries average: 389 dwellings) except for Ukraine and Kazakhstan as compared to the EU15 (453 dwellings).

Figure 4: Housing Stocks

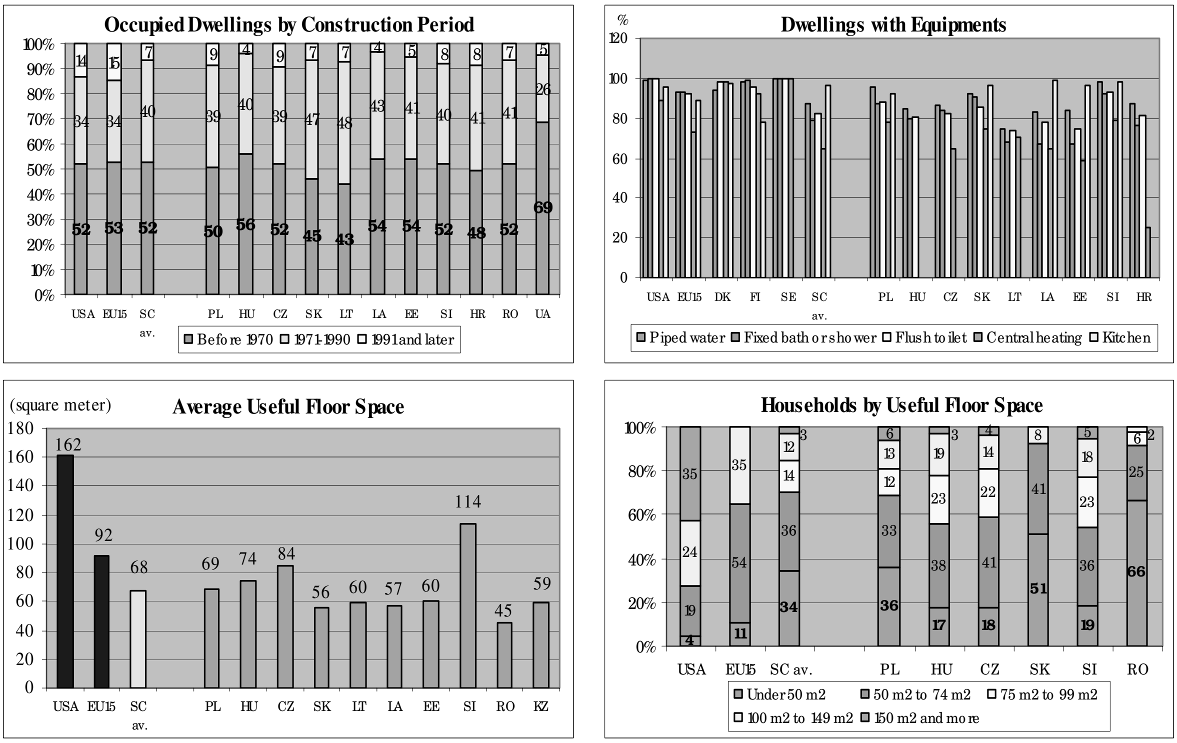


(Source) United Nations Economic Commission for Europe, National Agency for Enterprise and Housing of Denmark * SC av.: study countries average

Housing quality is in the crucially low level in the region.

The following three conditions are key factors to assess housing quality: 1) construction period; 2) equipment installed in a house; and 3) useful floor space. First, as for the construction period, approximately 52% of total occupied dwellings have been in existence for more than 30 years. This duration is not exceptional among European countries but, more importantly, over 90% of dwellings in study countries are houses built in the former communist era. Those houses are often described as poor quality housing because they were originally provided by governments operating on limited budgets and were given little maintenance. Building houses comfortable to live in was not in the states' interest at that time. Secondly, as seen in terms of the equipment installed in a house, study countries lack core equipment (e.g. piped water, fixed bath or shower, flush toilet, central heating and kitchen) in their houses as compared to the EU15 and the United States. Particularly, central heating is not well diffused in the area, which experiences a very cold winter (Central Europe and Baltic States: less than 70% of the dwellings) as compared to the advanced EU countries located in cold area (Sweden, Denmark and Finland: over 90%). Thirdly, the average useful floor space of dwellings is small in the region (roughly 68 m^2) in comparison with the EU15 (approx. 92 m^2). Moreover, around 34% of total households in study countries live in houses below 50 m^2 (for example, Slovak Republic 51% and Romania 66%). Taking those conditions into account, housing quality in study countries is still low as compared to the EU average level.

Figure 5: Housing Quality



(Source) United Nations Economic Commission for Europe, National Agency for Enterprise and Housing of Denmark * SC av.: study countries average

1-2. Supply of Housing

Small scale housing supply does not help to cover the relative housing shortage. New construction of dwellings tends to focus on the higher income market segment, which has yet to contribute to the average household's access to housing.

On the supply side of housing, the number of newly completed dwellings (including new construction, restoration, extension and conversion) is quite small in scale in study countries (roughly 2 dwellings per 1000 inhabitants) as compared to EU15 (approx. 6 dwellings). Although the volume of new construction has been slightly moving upward recently, it does not help to cover the relative housing shortage in the region.

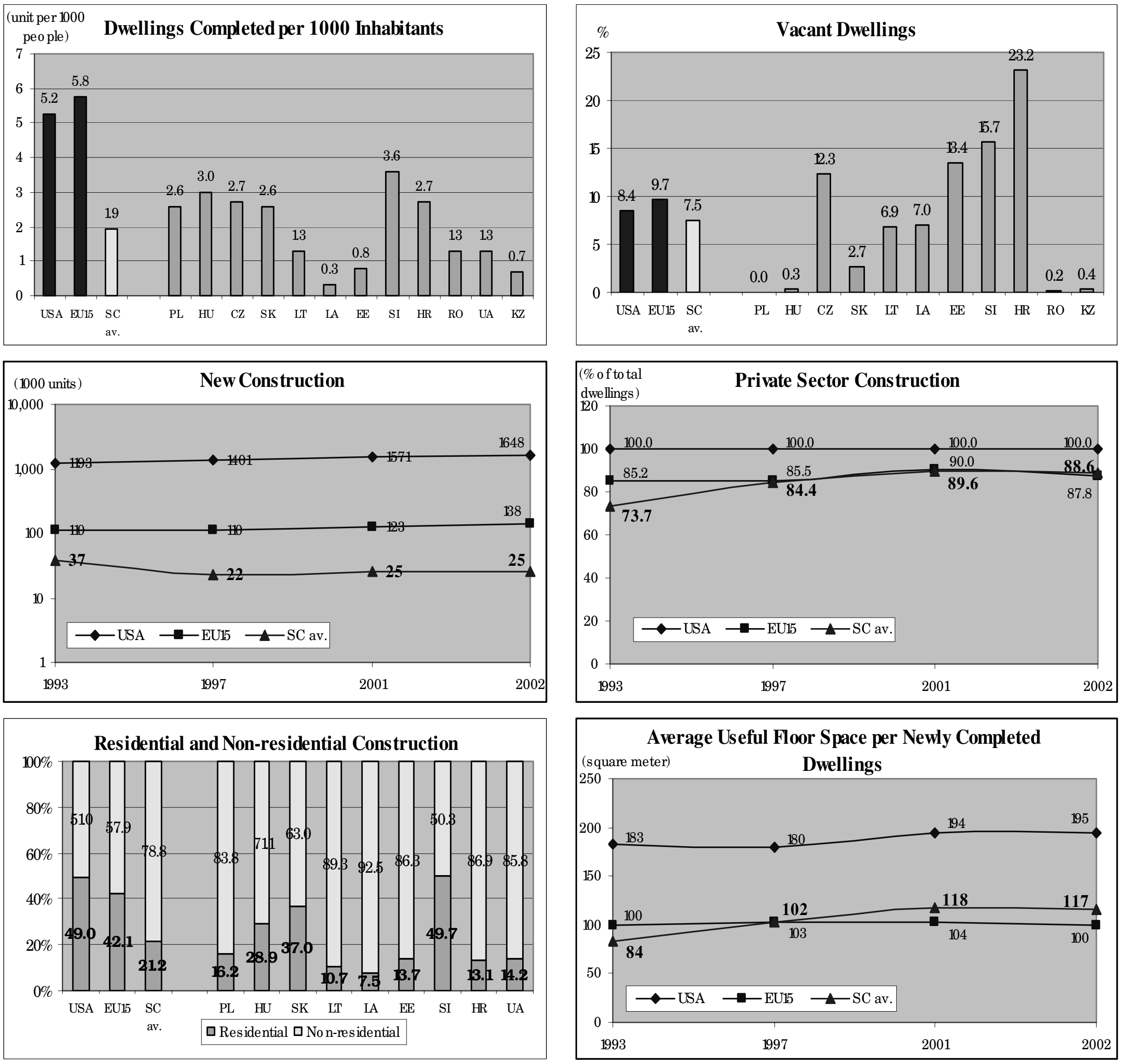
In this limited situation, the private sector has taken an active role in construction; i.e. approximately 90% of total dwellings have been completed by private developers in study countries. This seems to be a good development but includes some critical issues: 1) little effective use of vacant dwellings and 2) private developers' narrow interest in constructing luxury dwellings and/or commercial buildings.

First, the ratio of the vacant dwellings (approx. 8% of the total dwellings in the region) is below the EU15 level (approx. 10%) but some countries (Croatia, Czech Republic, Estonia and Slovenia) have shown high vacancy ratios (12-23%), which means that existing housing stocks have not been used effectively. To make the best of vacant dwellings, it might be necessary to improve their quality for the resale market.

Second, residential construction accounts for only a small portion of total construction value in the region (approx. 21% of the total). In other words, commercial construction accounts for roughly 80%

of the total construction value in transition economies. Furthermore, while the average useful floor space of dwellings is approximately 68 m^2 in the region, that of newly completed dwellings is around 117 m^2, which means that private developers tend to deal mainly with the construction of up-scale dwellings and/or commercial building construction with large space. This tendency has not helped improve the average households' access to housing in study countries.

Figure 6: New Construction



(Source) United Nations Economic Commission for Europe, National Agency for Enterprise and Housing of Denmark * SC av.: study countries average

1-3. Country Assessments

Taking account of the above mentioned analyses, the current performance of housing markets in transition economies was assessed in terms of the supply and demand conditions in accordance with the following three steps: 1) calculating the deviation of the performance from the EU15 average based on a normal distribution; 2) scoring the housing market performance; and 3) assessing the total performance of housing markets in study countries by means of the country assessment sheet developed from each score. Figure 7 indicates the aggregate result from Table 1.

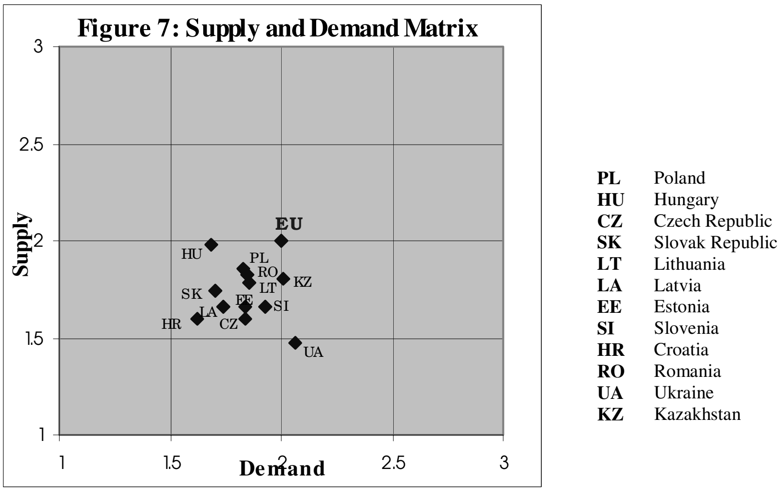


Figure 7: Supply and Demand Matrix

From Figure 7, the current performance of housing markets and the housing supply and demand potential in study countries can be analysed as follows:

- In Group 1 and 2 (new EU members and candidates), housing demand is quite limited and housing supply for households is quite insufficient. At present, no countries reached the EU15 level in terms of the housing supply and demand, but their demand potential are gradually approaching the EU level.

- In Group 3 (CIS), potential housing demand is slightly above the EU15 level in terms of large-scale housing stocks and high homeownership level backed by privatisation programs. Against this background, housing supply (new construction) is not so active in the region.

- As seen in the relatively high homeownership and household consumption for housing, the potential demand of housing is obviously as high as in the advanced EU countries. However, at present, several external factors, e.g. declining population, low macroeconomic performance, severe labour conditions, high price of housing and low quality of housing, are not supportive to efforts to create further housing demand in study countries.

- In the long term, gradually improving macroeconomic conditions (positive real GDP growth and increasing wage levels) may support the housing market by stimulating consumption by relatively large-scale working age population.

- On the supply side, new housing constructions, renovations and enlargements are not so active and there is little sign of sharp upward movement. As private developers tend to target commercial construction and/or wealthier households through the provision of luxury (spacious) housing, residential construction for typical households is inactive in spite of the apparent housing shortage in the region (except for Group 3). This results in low access to new dwellings for average households.

Table 1: Supply and Demand of Housing – Country Assessment Sheet

		PL	HU	CZ	SK	LT	LA	EE	SI	HR	RO	UA	KZ
Demand	**Population and Labour Force**												
	- Population growth	2-	1	2-	2-	1+	1+	1	2-	1	2-	1+	2
	- Labour force (working age population)	2-	1+	2+	2+	2+	2+	2+	2+	1	2	2-	3-
	Macroeconomic Performance												
	- GDP at current price	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-
	- Real GDP growth	3	3-	3-	3-	3	3	3	3-	2+	3	3	3
	- Inflation rate	1+	1	2-	1	2+	1	1+	1+	2-	1	1	1
	Labour Condition												
	- Monthly average wages (income level)	1	1	1	1	1	1	1	1+	1	1	1	1
	- Monthly average wages (growth rate)	3	3	3	3	3	3	3	2+	3	3	3	3
	- Unemployment rate	1	2+	2-	1	2	2-	2-	1+	1	2+	3-	2-
	Price and Consumption												
	- Housing price inflation as compared to all goods & services	2	2-	2+	1	2+	2-	2	2-	2	n/a,	n/a,	1
	- Household consumption for housing	2+	2-	2+	2+	1+	1+	2	2-	n/a,	n/a,	n/a,	n/a,
	Housing Stocks												
	- Dwellings per 1000 inhabitants	1	2-	2-	1	1+	2-	2	1+	2-	1+	3	3
	- Home ownership ratio	2+	3	1+	1+	3	2+	3	3-	n/a,	3	3	3
	Housing Quality												
	- Occupied dwellings constructed before 1971 (over 30-year)	2+	2-	2	2+	2+	2	2	2	2+	2	1+	n/a,
	- Dwellings with equipments - Piped water	2+	2-	2-	2	1+	2-	2-	2+	2-	n/a,	n/a,	n/a,
	- Fixed bath or shower	2-	1+	2-	2-	1	1	1	2	1+	n/a,	n/a,	n/a,
	- Flush toilet	2-	1+	2-	2-	1+	1+	1+	2	1+	n/a,	n/a,	n/a,
	- Central heating	2+	n/a,	2-	2	2	2-	2-	2+	1+	n/a,	n/a,	n/a,
	- Kitchen	2+	n/a,	n/a,	2+	n/a,	2+	2+	2+	n/a,	n/a,	n/a,	n/a,
	- Average useful floor space	1	1+	2-	1	1	1	1	3-	n/a,	1	n/a,	1
	- Households living in dwellings under 50㎡	1	1	1	1	n/a,	n/a,	n/a,	1	n/a,	1	n/a,	n/a,
Average Performance (sum of scores divided by the number of items)		2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	2	2
Supply	Newly completed dwellings per 1000 inhabitants	2-	2-	2-	2-	1+	1+	1+	2-	2-	1+	1+	1+
	Occupancy level (from the ratio of vacant dwellings to the total)	2+	2+	2-	2+	2+	2+	2-	2-	1+	2+	n/a,	2+
	New construction by private sector	2+	2+	1+	2-	2+	3-	2+	1+	1+	2	1+	2+
	Ratio of newly completed residential construction to the total construction value	1	1+	n/a,	2-	1	1	1	2+	1	n/a,	1	n/a,
	Average useful floor space per dwelling completed (size)	2	2+	2-	1+	2	1	2	1+	3-	2-	2+	1+
Average Performance (sum of scores divided by the number of items)		2-	2	2-	2-	2-	2-	2-	2-	2-	2-	1+	2-

(Notes) Methodology

1. Performance Deviation from the EU15 level: The normal distribution made out from the data on EU15 countries is used in order to assess how the performance in each study country has approached the EU level as a measure. All items measured are based on the statistics on Annex 1; where the assumption is as follows: 1) Mean: the value of the EU15 average; 2) Standard deviation (STDEV): the range of EU15 countries; and 3) Normal distribution (NORMDIST): in the excel calculation formula, NORMDIST (x, mean, STDEV, cumulative), where "x" is the value of performance in the study country and "cumulative" is set on "TRUE" (i.e. cumulative distribution).

2. Scoring: Based on the following scoring table, each condition influential in the housing market was rated from 1 (relatively low performance) to 3 (relatively high performance) as compared to the EU15 level; where the rating is classified into seven categories in terms of the normal distribution: 1: much worse than EU15; 1+: worse than EU15; 2-: slightly worse; 2: EU15 level; 2+: slightly better than EU15; 3-: better than EU15; and 3: much better than EU15.

Scoring Table

NORMDIST	- 0.02	0.03 - 0.16	0.17 - 0.44	0.45-0.54	0.55 - 0.84	0.85 - 0.98	0.99 -
Score (A)	1	1+	2-	2	2+	3-	3
Score (B)	3	3-	2+	2	2-	1+	1

	Score (A) Group (higher ratio means better condition)	Score (B) Group (higher ratio means worse condition)
Housing Demand-Creation Factors		
1. Population and Labour Force	Population growth, Labour force	
2. Macroeconomic Performance	GDP at current price, Real GDP growth	Inflation rate, Unemployment rate
3. Labour Condition	Monthly average wages and the growth	
4. Price and Consumption	Household consumption for housing	Housing price inflation
5. Housing Stocks	Dwellings per 1000 inhabitants, Owner occupied dwellings (homeownership)	
6. Housing Quality	Dwellings with equipments, average useful floor space	Housing constructed before 1971 (old construction over 30 years; higher ratio means older construction), Households living under 50 m^2
Housing Supply-Driving Factors	Dwellings completed per 1000 inhabitants, Occupied dwellings (from vacant dwellings), Private sector construction, Residential construction	Average useful floor space per dwellings completed (higher ratio means more luxury dwellings; i.e. low access to new dwellings for households)

3. Country Assessment Sheet: All analyses above were translated into country assessment sheet in Table 1. In order to recalculate the average performance in each study country, 0.3 point is given to "+" and deducted from original point in "-" for convenience sake.

2. Housing Finance Markets

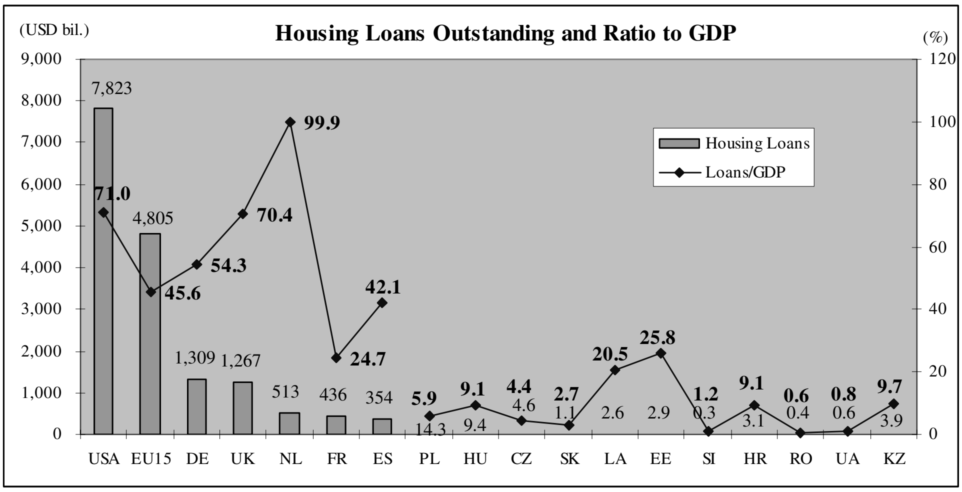
Housing finance markets in transition economies are still in an early stage of development, not to mention mortgage lending (house used as collateral). However, there are some favourable signs in these markets. This chapter analyses the housing finance markets in terms of the primary (lending) and secondary (funding) markets, referring to direct mortgage lending and mortgage-backed funding.

2-1. Primary (Lending) Markets

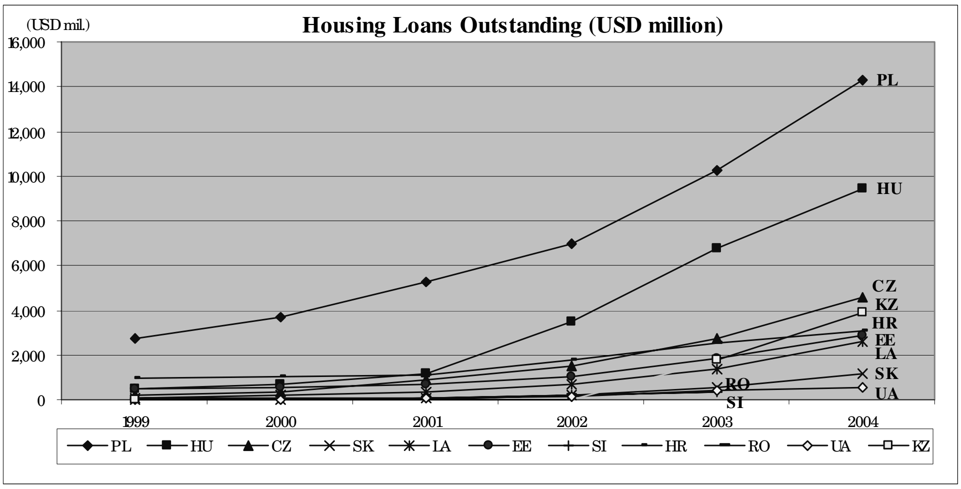
2-1-1. Housing Loans Outstanding

Housing finance markets are still quite small in scale in study countries. As shown in Figure 8, the outstanding balance of housing loans in the region remains well below the level of advanced European countries. The ratio of housing loans to GDP in EU15 countries is about half of GDP (46% in 2003) while those in study countries are below 26%, with most in the range of 1-9%. Despite the small size, however, the lending market for housing in the region has been sharply growing of late, with average growth of roughly 65% per annum. This rate is significantly above the EU15 growth of 7% (2003). In this context, it should be noted that the Hungarian, Estonian and Kazakhstan markets have been rapidly developed with mortgage lending recently but other markets still rely primarily on deposit based lending, though their mortgage markets are growing (explained later). Mortgage lending is closely linked to the secondary market funding with risk control. These countries are obviously in the midst of a transition process from deposit-based lending to market-based lending (mortgage lending).

Figure 8: Housing Loans Outstanding



(Source) European Mortgage Federation, OECD Market Survey on Housing Finance 2004
USA, EU, SI & RO: data in 2003, Others: 2004 * 1USD=1.132EUR (2003)



(Source) OECD Market Survey on Housing Finance 2004 * PL, SK & HR: data in June 2004

2-1-2. Major Products

Mortgage products vary among EU15 countries; i.e. different interest rates (fixed and/or adjustable), different maximum maturities (15-30 years) and different LTV (loan-to-value) ratios (50-90%). As shown in Table 2, mortgage products in study countries also vary but do have a few similarities as follows:

- Fixed-rate mortgage is relatively widespread, but floating-rate mortgages also exist;
- Mortgage products are mostly accompanied with government subsidy except for Latvia and Kazakhstan;
- Foreign currency-denominated loans have been growing;
- Relatively long-term maximum maturity (15-40 years) is offered; and
- Relatively high LTV loans are offered.

First of all, the fixed-rate mortgage is a flagship product in all study countries, but the floating rate (inter-bank offered rate, 3M-1Y) is also used in mortgage loan products. Mortgage rates are usually well below the long-term credit rates provided by commercial banks because of the government subsidy in most of the countries, where the typical interest rate is around 4-8% though some differences exist depending on the type of product. In addition to standard fixed-rate loans, Poland and Hungary have adopted the adjusted-rate mortgage, namely the dual-indexed mortgage (DIM) in Poland and the differed-payment mortgage (DPM) in Hungary. The DIM is an inflation-linked mortgage loan, covering the interest due by means of two variable indices: market interest rates and borrowers' income index (wage index). The DPM is a similar product to DIM, which secures low fixed-rate loans for households with differing repayments depending on the difference between the market rate and the preset fixed rate. In Poland, DIM used to be active at the early stage of the mortgage lending but demand for the product has been critically decreasing because of its complicated nature.

Second, mortgage loans in the region, except for Latvia and Kazakhstan, are mostly subsidised by the government (interest rate payments, downpayment subsidy, etc.). Mortgage loans used to play a significant role in the overall housing policy for homeownership in the region. This approach was initially effective but now that housing privatisation has almost been completed in transition economies (i.e. the initial purpose has been achieved) further promotion of government subsidies for mortgage loans may bloat the national budget (potential budget deficit). For this reason, for example, Poland, Hungary and Lithuania have tried to reform their government subsidy programs although their markets remain highly subsidised. Similarly, the Czech Republic, the Slovak Republic, Romania and Ukraine also have highly subsidised housing finance markets. Another concern with subsidies is that subsidised loans may suppress further competition in the mortgage lending market.

Third, foreign currency-denominated loans (EUR/USD) have been rapidly growing in most of the countries, which are based on EURIBOR(EUR), LIBOR(USD) and CHFLIBOR(CHF). In Poland, roughly half of housing loans are foreign currency-denominated loans (50% of the total housing loans; 77% of the mortgage loans originated by mortgage banks in June 2004). Also in Hungary, foreign currency-denominated loans have been growing since they were introduced in 2004. These sorts of products give rise to exchange rate risk.

Fourth, a relatively long-term maturity is a typical feature of mortgage products in the region. In some countries, the interest rate subsidy for long-term mortgage loans covers the loss between the preset fixed rate and the market rate, which will be helpful for borrowers but may bloat the national budget. Also, it is worth noting that while borrowers benefit from a fixed rate during inflationary regimes, such loans are not beneficial for borrowers in times of declining market rates. At present, as inflation rates in study countries are still higher than the EU level (i.e. the market lending rates are also high basically) mortgages with long-term fixed rates may function well in the region for the time being.

Table 2: Typical Mortgage Products

		Type of Mortgage	Maturity	Av. LTV	LTV Limit
Transition Economies	**Poland**	Fixed / Floating rate (with govt. subsidy) Adjusted rate (dual indexed mortgage)	20-25 years ($\leq$32.5y)	40-60%	$\leq$100%
	Hungary	Fixed / Floating rate (with govt. subsidy) Adjusted rate (differed payment mortgage)	15-20 years	40-50%	$\leq$60, 70, 80%
	Czech Republic	Fixed rate (with govt. subsidy)	5-30 years	47%	$\leq$70%
	Slovak Republic	Fixed rate (with govt. subsidy)	4-30 years	n/a,	$\leq$70%
	Lithuania	Fixed / Floating rate (with govt. subsidy)	15-20 years	n/a,	$\leq$80, 95%
	Latvia	Fixed / Floating rate	10-40 years	75-90%	$\leq$100%
	Estonia	Fixed / Floating rate (with govt. subsidy)	$\leq$40 years	75%	$\leq$80, 90%
	Slovenia	Fixed / Floating rate (with govt. subsidy)	10-20 years	33-60%	n/a,
	Croatia	Fixed / Floating rate (with govt. subsidy)	15-20 years	n/a,	$\leq$100%
	Romania	Fixed / Floating rate (with govt. subsidy)	20 years	75%	n/a,
	Ukraine	Fixed rate (with govt. subsidy)	3-15 years	70-80%	n/a,
	Kazakhstan	Fixed rate	$\leq$20 years	70-90%	n/a,
EU15	**Netherlands**	Fixed rate	30 years	90%	
	Denmark	Fixed rate	30 years	80%	
	United Kingdom	Variable rate (or short term fixed rate)	25 years	69%	
	Germany	Fixed rate	25-30 years	67%	
	Sweden	Fixed/Variable rate	30 years	77%	
	Portugal	n/a,	15 years	83%	
	Ireland	Variable rate (or short term fixed rate)	20 years	66%	
	Spain	Fixed/Variable rate	15 years	70%	
	Finland	Variable rate	15-18 years	75%	
	Belgium	Fixed rate	20 years	83%	
	France	Fixed rate	15 years	67%	
	Luxembourg	n/a,	20-25 years	n/a,	
	Greece	Fixed rate	15 years	75%	
	Italy	Fixed/Variable rate	15 years	55%	
	Austria	Fixed rate	20-30 years	60%	

(Source) Transition Economies: OECD Market Survey on Housing Finance 2004 * data in 2003 year-end (% of mortgage loan value; CZ: % of market value) *EU15 Countries: Pricewaterhouse Coopers European Economic Outlook 2004;* data in 2002

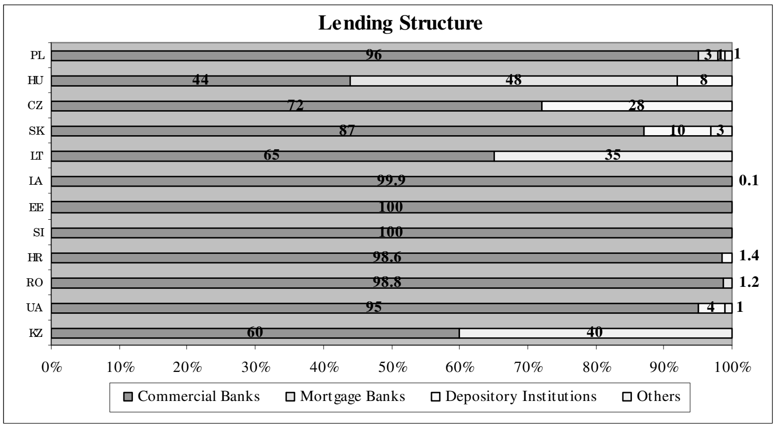
Lastly, relatively high LTV loans are available to borrowers in the region. In Poland, Latvia and Croatia, the absolute lending limit is 100% of the total loan value. In other countries, it is 70-80%. In the case of loans backed by mortgage insurance, the LTV ratio rises to around 90-95% (Lithuania and Estonia). From empirical data, high LTV lending tends to cause high default risks and to be volatile when the market turns. Against the backdrop of high LTV loans, there are several government subsidy programs, and mortgage insurance in some countries.

2-1-3. Lending Structure

Market participants in study countries can be classified into four types of lenders: 1) commercial banks, 2) mortgage banks, 3) depository institutions (contract savings institutions), and 4) national housing funds. Figure 9 indicates the lending structure in the region. Looking more closely at these categories, four major trends can be identified:

- Large-scale universal banks are predominant in the housing loan market (oligopolistic markets);
- Specialised mortgage banks are not yet major players but are rapidly growing, particularly in Hungary;
- Depository institutions are losing market share as mortgage lending grows; and
- National housing funds play a supportive role in mortgage markets in some countries.

Figure 9: Lending Structure



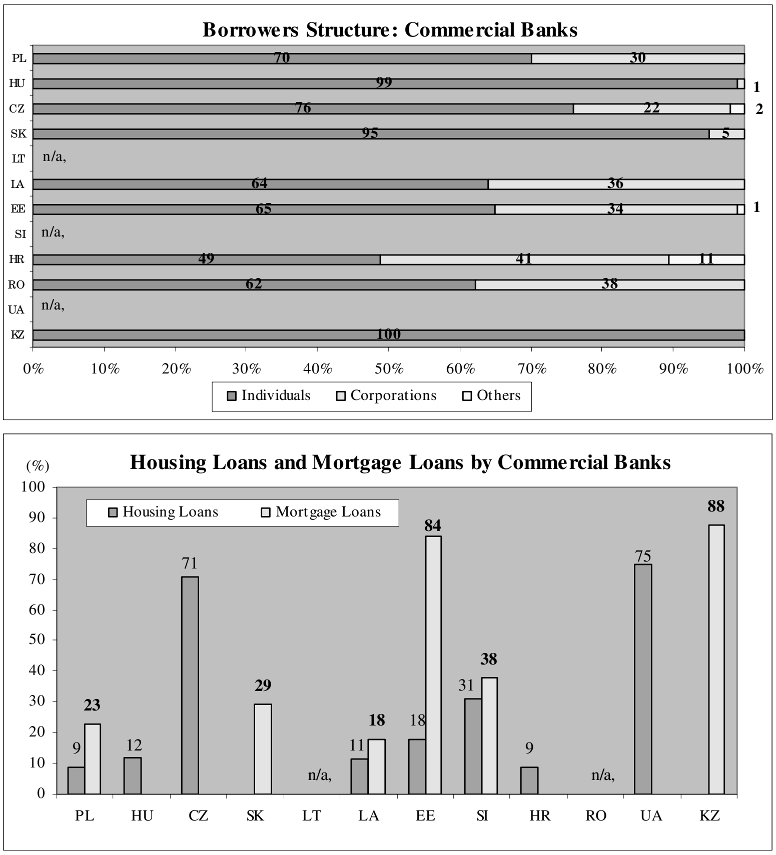
(Source) OECD Market Survey on Housing Finance 2004 * Data in 2003 (HU: Q32004, LT: 2002, HR: June 2004, KZ: 1 Jan 2005)

Commercial banks are predominant in the housing finance markets in transition economies, where a few leading domestic banks and foreign-owned commercial banks have created oligopolistic markets.

Commercial banks, as universal banks, have played an important role in providing housing loans to households in the region. In fact, they are currently the dominant providers of housing finance in study countries. More precisely, a few large-scale state-controlled banks and foreign-owned commercial banks (especially Germany-based banks) tend to dominate housing finance markets in the region, i.e. oligopolistic markets by commercial banks. The ratio of housing loans to total bank assets is roughly 29%, on average, in study countries, which is above the level of Euro area (15%), but there is a wide disparity (for example, Ukraine: 75%, the Czech Republic: 71% and Slovenia: 31%). Also, the share of mortgage loans to total banking housing loans is around 47% in the region. In Estonia and Kazakhstan, such rates are 84% (2003) and 88% (2005) respectively and growing. Commercial banks mainly target individual households in their housing finance markets (roughly 76% of the total borrowers). In this context, two specific facts should be noted: 1) the high market share of a Hungarian universal bank is attributed to its affiliated mortgage bank; and 2) only commercial banks with mandatory licenses are able to offer mortgage loans in the Czech Republic and the Slovak Republic.

Selected countries' conditions are indicated as follows:

Figure 10: Commercial Banks



(Source) OECD Market Survey on Housing Finance 2004 * Data in 2003 (HU: Q32004, LT: 2002, HR: June 2004, KZ: 1 Jan 2005)

In Poland, commercial banks are the largest players in the housing finance market, accounting for 96% of the total lending in 2003. In particular, three major banks alone account for more than half of the market: 1) PKO BP (largest state controlled bank); 2) Pekao SA (second largest bank owned by the Italian Unicredito); and 3) BPH PBK (third largest bank owned by German HVB Group). PKO BP was privatised and has recently achieved its initial public offering (IPO) on the Warsaw Stock Exchange[1], although the government still holds the largest portion of shares. In 2004, those banks expanded their housing loan business for individuals and achieved the highest growth. In this context, Pekao SA increased their share of the Polish mortgage lending market by 17% in 2004. However, at present, the Polish mortgage market itself seems to be still small in scale though it is growing.

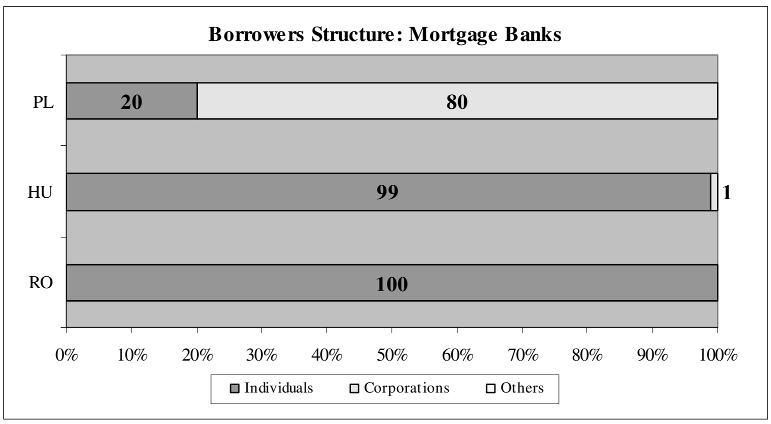
In Hungary, the housing finance market can be described as a subsidy-driven market. The OTP Bank Group (originally the National Savings Bank, now privatised) and large- and medium-scale foreign-owned commercial banks have become major players in the market by making use of government subsidy schemes. Particularly, the OTP Bank Group dominated 65% of the Hungarian market in 2003, which included the almost 41% market share of its subsidiary company OTP Mortgage Bank Ltd. Taking the activities of subsidiaries into account, housing loan operations of pure commercial banks, excluding the operations of specialised mortgage banks, accounted for 44% of the total lending in 2003. The ratio of housing loans to total banking assets is around 12%, which is approaching the Euro zone level.

In both the Czech Republic and the Slovak Republic ten commercial banks with a mortgage banking license have participated in mortgage lending. In the Czech Republic, mortgage lending was introduced with legal setting in 1995. In the Slovak Republic, it started in 1997. Commercial banks have accounted for over 70% of the countries' housing finance markets, targeting individual households.

Mortgage banks have yet to become major players in the region, but been developed rapidly in particular countries.

Mortgage banks, which are specialised mortgage lending institutions, have emerged and rapidly developed recently, particularly in Hungary. Mortgage banks are specialised institutions that originate, sell and service mortgage loans (i.e. housing loans with borrowers' pledging the property as collateral). They usually provide favourable interest rates (fixed and/or adjusted-rates often below comparable market rates) and loans with relatively long-term maturities to borrowers. Their fund raising methods basically rely on the secondary mortgage market, for example, via issuance of mortgage-backed securities in the United States and mortgage covered bonds in European countries (see the next section 2-2 for details). Currently, four mortgage banks are operating in Poland and three banks in Hungary (Table below). Romania has two mortgage companies to provide mortgage loans but they seem not to be genuine mortgage banks because of no secondary mortgage market for funding. There are legally no specialised mortgage banks in either the Czech Republic or the Slovak Republic but, as mentioned above, ten commercial banks in both countries hold a license for mortgage banking activities and their specialised divisions are dealing with mortgage loans, i.e. these divisions can be regarded as mortgage banks. Mortgage banks in Poland mainly target corporations for borrowers while Hungary and Romania do individual households. Details regarding Polish and Hungarian conditions are indicated as follows:

Figure 11: Mortgage Banks



(Source) OECD Market Survey on Housing Finance 2004 * Data in 2003 (HU: Q32004)

	Mortgage Banks	Parent Company	Established Date
Poland	Rheinhyp-BRE Bank Hipoteczny SA	BRE Bank SA (Polish leading bank)	12 March 1999
	HypoVereinsbank Bank Hipoteczny SA	HVB Group (Germany)	01 December 1999
	Slaski Bank Hipoteczny SA	ING Group (Netherlands)	08 November 2000
	Nykredit Bank Hipoteczny SA	Nykredit A/S (Denmark)	18 November 2002
Hungary	Földhitel és Jelzálogbank (FHB)	53.2% of shares are owned by the State	March 1998
	HVB Mortgage Bank Inc.	HVB Group (Germany)	1998
	OTP Mortgage Bank	OTP Group (Hungarian leading bank)	2001
Romania	Domenia Credit	(mortgage company)	n/a,
	IMO Credit	(mortgage company)	n/a,

(Source) OECD Market Survey on Housing Finance 2004 * Data in 2003

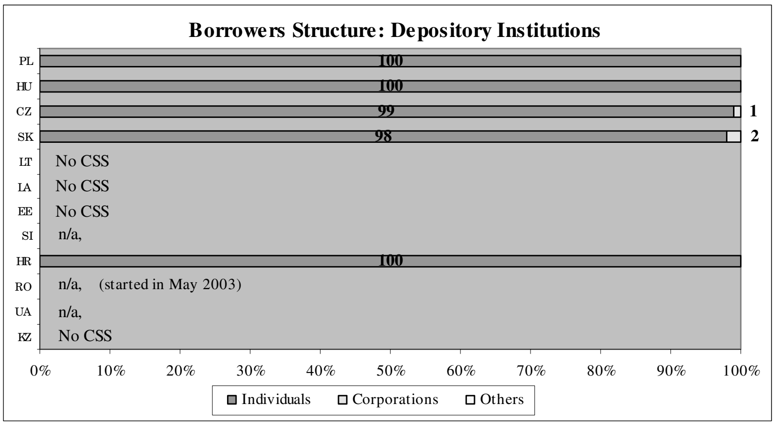
In Poland, mortgage banking is very small in scale (only 3% in 2003) at present. Mortgage banks' operations just started in 1999. However, the total mortgage loans provided by mortgage banks have been rapidly growing (annual growth: up to 32%). Currently, four mortgage banks are operating in Poland, targeting corporations as customers: 1) Rheinhyp-BRE Bank Hipoteczny SA (first-established Polish mortgage bank); 2) HypoVereinsbank Bank Hipoteczny SA (mortgage bank owned by German HVB Group); 3) Slaski Bank Hipoteczny SA (mortgage bank owned by Dutch ING Group); and 4) Nykredit Bank Hipoteczny SA (Danish largest mortgage bank's subsidiary).

In Hungary, mortgage banking has been growing explosively with issuance of mortgage covered bonds occurring recently. In 2003, mortgage banks exceeded commercial banks in terms of market share for the first time, i.e. mortgage banks accounted for 48% of the total housing finance market in 2003 (commercial banks: 44%). Currently, three mortgage banks are operating in Hungary: 1) FHB (state owned company); 2) HVB Mortgage Bank (subsidiary of German HVB Group); and 3) OTP Mortgage Bank (subsidiary of OTP Group). The OTP Group, as mentioned, have dominated the large portion of mortgage lending market in Hungary through its affiliated mortgage bank.

Depository institutions (contract savings institutions) have been losing market share as mortgage lending grows in the region.

Deposit-based lending or contract savings schemes (CSS) used to be popular in the region, targeting households who wished to purchase their houses. The CSS provides housing loans with a favourable interest rate (below the market rate) and term of maturity once deposits collected from applicants (with a low deposit rate) accumulate up to a certain level. Recently the market structure has been dramatically changed. As mortgage banks have been growing, depository institutions that adopt a CSS have been significantly losing market share, particularly in Poland and Hungary. However, there is a lenders' demand for cultivating a new market through the introduction of CSS in Lithuania and Romania[2], but it should be noted that they highly rely on deposit based lending, not mortgage lending. Selected countries' conditions are indicated as follows:

Figure 12: Depository Institutions



(Source) OECD Market Survey on Housing Finance 2004 * Data in 2003 (HU: Q32004, LT: 2002, HR: June 2004, KZ: 1 Jan 2005)

In Poland, there were two types of contract savings schemes: 1) kasa mieszkaniowa (KM) based on the Law on Selected Forms of Housing Support in 1995, which is a system basically operated under the existing commercial banks; and 2) kasa oszczednosciowo-budowlana (KOB) based on the law in 1997, which was a system managed through independent specialised institutions modelled on the German and Austrian *Bausparkassen* system. However, the KOB system was abolished in 2001 because of its insufficient legal framework. At present, only the KM system is operating. Currently, three major commercial banks (BPH SA, Pekao SA and ING Bank Slaski SA) have opened specialised departments to conduct a contract savings scheme according to the KM system but new savings contracts have been withheld since 2001. The ratio of loan initiations to the total contracts is very low (roughly 30%) and the market share is very small in scale (below 1% in 2003). As the tax incentive scheme for this system was abolished in 2002, further demand is not expected in the Polish contract savings scheme.

In Hungary, there are two types of depository institutions: 1) savings co-operatives and 2) contract savings institutions. Currently, over 100 savings co-operatives and two contract savings institutions are operating: for the latter, OTP Building Society and Fundamenta (Germany and Austria owned institution). Similar to Poland, depository institutions' share of housing finance market is very small (roughly 8% in 3Q 2004) and is sharply decreasing (e.g. savings co-operatives: 18.9% in 2001 to 7.6% in 2003). The main reasons for the drop in loan volume include the limitation of their activities: 1) savings co-operatives are not allowed to provide subsidised housing loans and foreign currency denominated loans; and 2) contract savings institutions enjoy a subsidy through tax allowance but the maximum amount is strictly limited.

In the Czech Republic, modelled on the German and Austrian *Bausparkassen* system, contract savings schemes started in 1993; they are backed by a government subsidy program (savings bonuses for savers: annual 25% of the savers' deposits). Currently six institutions are operating in the Czech Republic, which accounted for 28% of the total lending for housing in 2003. It seems that this scheme has succeeded in encouraging housing privatisation but has not been actively used for purchasing new houses: i.e. large portion of granted loans has been used for purchasing houses (encouraging homeownership), but only a small portion of which has been used for purchasing new houses.

Similar to the Czech Republic, the Slovak contract savings schemes, which started in 1992, are modelled on the German and Austrian *Bausparkassen* system. Currently three institutions are operating (Prvá stavebna sporitel'na, a.s.; VÚB Wüstenrot, a.s.; and CSOB stavebná sporitel'na, a.s.) and enjoying the government subsidy program (savings bonuses for savers: annual 15% of the savers' deposits). However, in order to reduce its budgetary burden, the government has considered amending the Act on Housing Savings for the stabilisation of the national budget.

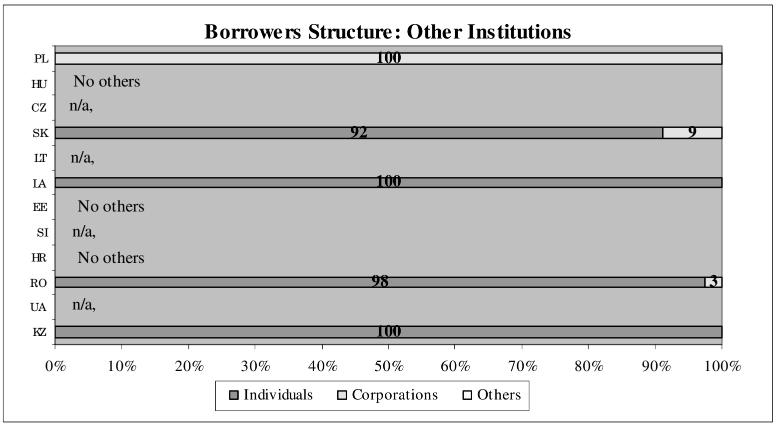
National housing funds play a supportive role in housing finance markets in the region.

Besides the above mentioned participants, national housing funds play a supportive role in housing finance markets in Poland, the Czech Republic, the Slovak Republic, and Slovenia. These are public funds specially established by the government (or municipalities) in order to encourage developers and borrowers to construct social rental housing and/or purchase houses through preferential loans. The source of capital for housing funds is usually revenue from housing privatisation but the schemes can be a budgetary burden. For this reason, the National Housing Agency (state owned company) in Romania stopped its lending activity in February 2003. In Lithuania, lenders had provided soft loans subsidised by the national fund in the framework of the Bustas program but the current situation is unclear.

In addition to the above mentioned players, insurance companies and non-banks have also recently participated in mortgage lending markets in some countries.

Polish and Slovak conditions are indicated as follows:

Figure 13: Other Institutions (National Housing Fund, etc.)



(Source) OECD Market Survey on Housing Finance 2004 * Data in 2003 (HU: Q32004, LT: 2002, HR: June 2004, KZ: 1 Jan 2005)

	Other Institutions	Remarks
Poland	National Housing Funds	
	Mortgage Fund	Non-active
Hungary	Insurance companies	No- loans initiated so far. Act as a syndicated partner of a mortgage bank.
Czech Republic	State Housing Development Fund	
Slovak Republic	State Housing Development Fund	
Lithuania	Bustas Program	Soft loan subsidised via the national fund (data in 2002)
Latvia	Credit Unions	32 unions. Very small market share (0.001%)
	Insurance companies	17 companies
Slovenia	National Housing Fund	
Romania	National Housing Agency	Stopped its lending activity in Feb 2003
Ukraine	Credit Unions	0.5-1.0% market share
Kazakhstan	BTA Mortgage company OJSC	Non-bank
	Astana Finance OJSC	Non-bank

(Source) OECD Market Survey on Housing Finance 2004 * Data in 2003

In Poland, there are two types of public funds: 1) the Mortgage Fund and 2) the National Housing Fund. Initial mortgage lending (in early 1994) was mostly based on the dual-indexed mortgage (DIM) provided by the Mortgage Fund program, which was established by the Polish government through the support of international financial institutions (World Bank and USAID). The Mortgage Fund is a liquidity facility to fund DIM. Unfortunately, this scheme is not active at the moment because of little demand for DIMs. Another fund is the National Housing Fund, which has been operating since 1995. This scheme provides housing co-operatives (co-operative tenancy) and social housing associations (non-profit developers) with preferential long-term loans for the construction of social rental housing in order to enhance rental housing affordability. The fund can cover up to 70% of the project value by means of another dual-indexed loan, which covers interest due by means of two variable indexes: the rediscount rate of the National Bank of Poland (floating rate ranging from 3.5% to a half of its rediscount rate per annum) and the construction price index. Lending volume of both public funds is very small (below 1% to the total lending for housing in 2003). Their target customers are corporations.

In the Slovak Republic, the State Housing Development Fund has played a significant role in the housing finance market, which has been growing. This fund is basically designed to provide preferential long-term loans and non-returnable bonuses for construction and renovation of apartment flats to borrowers, targeting individual households (92% of the fund in 2003) by means of government subsidies. Some concerns will be that this scheme may bloat the national budget and limit competition in the Slovak housing finance market.

2-2. Secondary (Funding) Markets

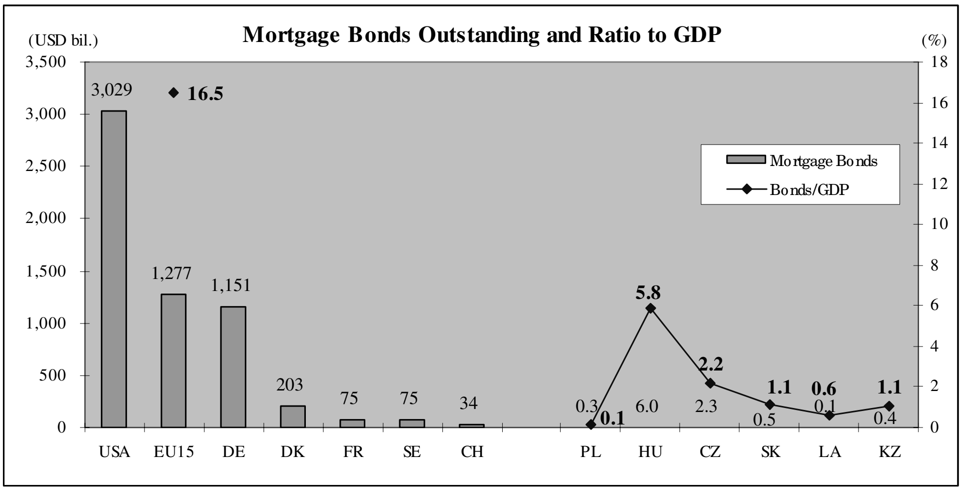
2-2-1. Funding Instruments

Study countries have developed their own funding instruments such as mortgage bonds and contract savings schemes, which reflect their historical and cultural backgrounds. Funding through secondary markets in transition economies is a relatively new concept, but the mortgage covered bond market has been rapidly developing, modelled on the German *Pfandbrief* (covered bond). Currently, half of the study countries make use of mortgage bonds for funding in parallel with banks' deposits but the remaining half still rely only on contract savings and short-term deposits. Mortgage covered bond is a securitisation scheme in which bonds backed by selected mortgages pooled by lenders are sold to investors through the secondary market (bond market). There is currently no mortgage-backed securities (MBS) market in the region but Poland has recently established the legal framework of MBS through the amended Banking Law and the Investment Funds Law enacted in 2004. MBS have been most developed in the United States, although six other countries have their own MBS markets in Europe: Belgium, Spain, France, Ireland, Netherlands and United Kingdom. MBS are another securitisation scheme in which securities backed by selected mortgages pooled by lenders are sold to investors through the secondary market (securities market). The major difference between covered bonds and MBS is that loan assets remain on the lender's balance sheet in the covered bond scheme (on-balance sheet securitisation) while such assets are removed from a lender's balance sheet in the MBS scheme (off-balance sheet securitisation). One effect is that credit and prepayment risks remain with issuers in the former arrangement but are transferred to investors in the latter. Therefore, issuance of covered bonds requires strong risk management techniques for issuers. In this section, mortgage bonds in study countries are focused on as a funding instrument through the secondary market.

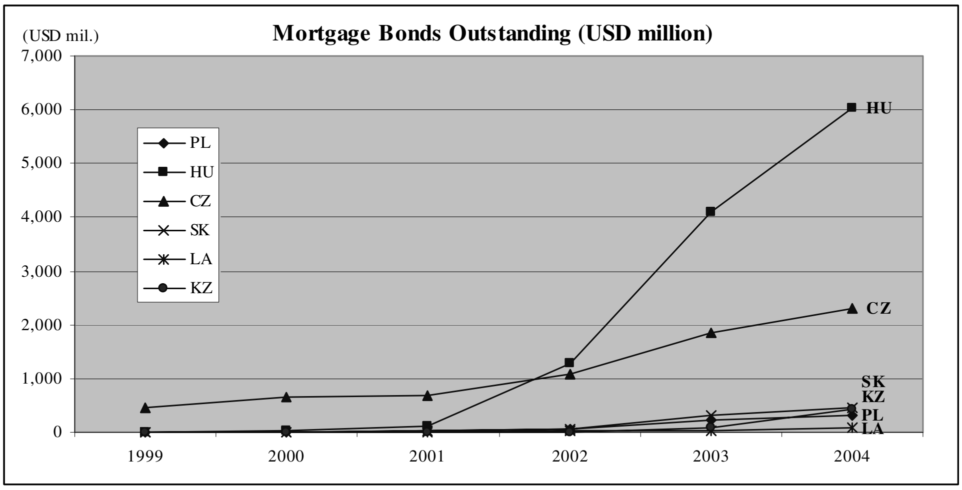
2-2-2. Mortgage Bonds Outstanding

At present, Poland, Hungary, the Czech Republic, the Slovak Republic, Latvia, and Kazakhstan have their own mortgage bond markets, but these markets are quite small in scale. This fact is evident when considering the low volume of mortgage lending in the region. As shown in Figure 14, the outstanding balance of mortgage bonds is below 6% of GDP in the region, which is quite a low level compared to the EU15 (16.5% in 2003). Against this backdrop, the mortgage bond market has been rapidly growing in respective countries, with average growth at roughly 113% in terms of the outstanding balance of mortgage bonds (2004). Around 60-70% of mortgage loans have been used as cover assets for mortgage bonds in Hungary, the Czech republic and the Slovak Republic, which is close to the Swedish level (65% in 2002), but such rates are below 4% in Poland, Latvia, and Kazakhstan. Polish and Hungarian conditions are reviewed below:

Figure 14: Mortgage Bonds Outstanding



(Source) European Mortgage Federation, OECD Market Survey on Housing Finance 2004
USA&EU15: data in 2001; DE,DK,FR,SE&CH: 2002; EU15(bonds/GDP): 2003; PL,HU,CZ,SK,LA&KZ: 2004



(Source) OECD Market Survey on Housing Finance 2004 * PL: data in Sept 2004, SK: data in June 2004

In Poland, funding through the secondary market is not yet popular. Mortgage bond issuance is only 1% of the total commercial debt securities. The source of capital for housing loans is still based on banks' short-term deposits (98% in 2003). This seems to impede the further development of the Polish mortgage bond market. Main issuers are three mortgage banks (Reheinhyp-BRE, HypoVereinsbank, and Slaski). Commercial banks with mortgage debt operations have not actively participated in the covered bond market because their main funding method is short-term deposits as mentioned above. By September 2004, three mortgage banks had brought to market 14 issues of covered bonds, which amounted to USD 324 million[3]. This amount accounted for around 40% of the mortgage loans originated by mortgage banks but it is a very small share of total mortgage lending. The issuance volume has been gradually growing but will be limited because the volume of mortgage loans itself is still very small in scale. Polish authorities have mentioned that possible reasons for this inactive market would be 1) the complicated process of creating the underlying mortgage loan portfolio (pooling process) for issuing mortgage bonds; 2) investment limits for investors (explained later); and 3) time consuming procedures of land registration and mortgage books (register).

In Hungary, the mortgage covered bond is the second biggest category of fixed-income instruments and the fastest growing market, representing one eighth of government bonds outstanding. Foreign investors have shown an interest in the Hungarian market recently, particularly in Euro-dominated issues of covered bonds. The volume of covered bonds outstanding was USD 6,020 million in 2004. The mortgage bond market has been explosively growing since 2002. However, the liquidity of covered bonds seems to be still low as compared to government bonds; i.e. monthly turnover of government bonds is 60% of the total stock while that of publicly issued mortgage bonds is only 2%.

2-2-3. Major Products

Mortgage bond products in study countries are quite similar to those in advanced European countries as shown in Table 3. Covered bond structures in most of countries are modelled on the German *Pfandbrief* scheme. From assets eligible for mortgage bonds, the products can be classified into two types: 1) mortgage covered bond and 2) public sector bond. The mortgage covered bond is a bond secured by cover assets comprising mortgage loans, while the public sector bond is backed by public sector loans that mortgage banks (or universal banks) granted to the government, central bank or international financial institutions such as the EBRD and the World Bank. In other words, mortgage loans and public sector loans are refinanced through the issuance of mortgage covered bonds and public sector bonds. Poland, the Slovak Republic and Latvia provide both types of bonds. Mortgage bond yields in the region are around 3-9% per annum, some of which are quite close to the benchmark government bond yield (10-y); i.e. relatively favourable interest rate backed by the creditworthiness. The maturity is relatively short-and middle-term (3-11 years) taking account of the long term maturity of mortgage loans. LTV limit of cover assets (60-75%) is equivalent to the EU level (mostly 60-80%).

In Poland, three mortgage banks have currently issued mortgage bonds denominated in three currencies: PLN, USD and EUR, where PLN bonds gain AAA rating and USD/EUR bonds do BBB+.

In Hungary, although the LTV limit of cover assets is at a maximum of 60% of the mortgage lending value, the average LTV of cover assets are 40-42%. Typical maturity of covered bonds is 3-10 years but FHB has issued covered bonds with the longest maturity of 15 years. The primary coupon type is fixed rate.

In Kazakhstan (KMC bonds), the coupon rate of bond is decided twice a year based on the movement of inflation linked index, where the upper and lower limit of interest rate is preset in order to avoid the market risk ("cap" and "floor" rate).

Table 3: Typical Mortgage Bonds

		Assets eligible for Bonds: Mortgage loans	Assets eligible for Bonds: Public sector loans	Bond Yield	10y govt. bond	Maturity	LTV Limit of Cover Assets
Transition Economies	**Poland**	✔	✔	6.0-7.0%	6.62%	3-10 y	60% [a]
	Hungary	✔		7.0-8.0%	7.95%	3-10 y	60% (av. 40-42%) [a]
	Czech Rep.	✔		2.7-7.5%	n/a,	5-7 y	70% [b]
	Slovak Rep.	✔	✔	9.32%	5.0%	5-11 y	70% [a]
	Latvia	✔	✔	3.76-3.90 (USD) 3.75-5.75 (LVL)	n/a,	3-10 y	60 / 75% [b]
	Kazakhstan	✔		Max. 4.5% [c]	n/a,	n/a,	n/a,
EU count.	**Denmark**	✔					40 / 60 / 70 / 80 (91)% [a]
	Germany	✔	✔				60% [a]
	Greece	✔					75% [b]
	France	✔	✔				60 / 80 / 100% [a b]
	Ireland	✔	✔				60 / 75% [b]
	Luxembourg	✔	✔				60% [a]
	Austria	✔	✔				60% [a]
	Portugal	✔					80% [b]
	Spain	✔	✔				70 / 80% [b]
	Sweden	✔					60 / 75 / 85% [b]
	Finland	✔	✔				60% [a]

(Source) OECD Market Survey on Housing Finance 2004, European Mortgage Federation "Mortgage Banks and the Mortgage Bond in Europe, 4th edition"

[a] % of the mortgage lending value [b] % of the market value [c] Interest rate is decided twice a year (floating). Max 4.5% in 2nd FX period.

2-2-4. Mortgage Bond System

Study countries having a mortgage bond market, except for Kazakhstan, have satisfied the UCITS directive, the European minimum standards for mortgage bonds (explained later). Therefore, their legal settings and systems of mortgage bonds are quite similar to other EU countries. Kazakhstan has developed its system modelled on *Fannie Mae* in the U.S., the German Savings and Loan Association and *Cagamas Berhad* in Malaysia; which system is also equivalent with the developed country's system. The basic system is drawn as follows:

- Mortgage bonds are legally protected;
- A register system of cover assets is established;
- LTV limit for funding through mortgage bonds is strictly determined;
- Additional funding beyond covered bonds (substitute collateral) is limited (10-20% of the cover pool); and
- Bankruptcy privilege is secured for bond creditors.

Selected countries' conditions are overviewed as follows[4]:

In Poland, the mortgage covered bond is legally registered and protected as "*List zastawny*". As a basic rule, the total nominal value of all outstanding mortgage bonds must not exceed the total nominal amount of mortgage-secured receivables. According to the principle of ongoing covers for mortgage bonds, interest on mortgage-secured receivables may not be lower than the amount of payable interest on outstanding mortgage bonds. Mortgage banks keep a mortgage cover register (mortgage cover account) to check whether or not a register is consistent with the cover principle, where registers for mortgage bonds must be separated from ones for public-sector bonds. Substitute collateral (e.g. term-deposit, loans and credits, non-covered bonds, etc.) is limited to maximum 10% of the cover pool, and must not exceed ten times the mortgage bank's equity during the first 5 years and then not do six times after 5 years. In cases of bankruptcy, mortgage cover registered receivables create a separate pool of assets for satisfying the mortgage bond creditors' claims (bankruptcy privilege). According to the Bankruptcy law in 2003, the separated bankruptcy property covering mortgage bonds can be sold to another mortgage bank without the permission of mortgage bond creditors.

In Hungary, the mortgage covered bond is legally protected as "*jelzaloglevel*", where the nominal amount and interest yield of mortgage bonds are completely covered. The law requires the mortgage bank to keep a mortgage cover register to document cover assets. Substitute collateral is limited to a maximum of 20% of the cover pool. In case of bankruptcy, covered bond creditors enjoy a bankruptcy privilege (only holders can execute enforced sales of cover assets).

In the Czech Republic, the mortgage covered bond is legally registered and protected as "*hypotecni zastavni list*". The nominal amount of covered bonds plus interest yields are completely covered by "regular coverage (only the principal)" or "substitute coverage (up to 10% of the cover pool by means of deposits at the Czech National Bank, government bonds and national bank bills)" in the cover pool. Universal banks issuing covered bonds need to carry "independent evidence" on the cover of mortgage bonds for monitoring. In case of the bankruptcy, covered bond creditors enjoy a bankruptcy privilege. Mortgage loans served as cover assets are higher ranking than normal mortgages, which enjoy preferential tax treatment.

In the Slovak Republic, the mortgage covered bond is publicly offered and legally protected as "*hypotekarny zalozni list*". The nominal amount of covered bonds is covered at least with the same amount and yields as the nominal amount of mortgage related receivables. The register of mortgages is kept by the mortgage bank separate from other documents in accordance with a special regulation of the National Bank of Slovakia. In this process, cover assets are recorded in one of two special registers: 1) mortgage loans and 2) municipal loans. Substitute collateral (e.g. deposits at another bank, purchased covered bonds and municipal bonds issued by another bank, government bonds, and national bank bills) is limited to a maximum of 10% of the cover pool. In the case of bankruptcy, bond creditors enjoy a bankruptcy privilege.

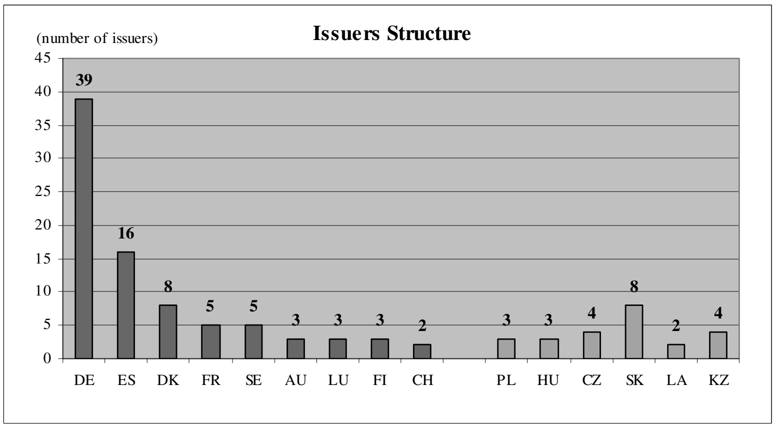
2-2-5. Issuing Structure

Issuers of mortgage bonds in the region can be classified into three types: 1) specialised mortgage banks; 2) universal banks with mandatory licenses and 3) mortgage conduits. In Poland and Hungary, only specialised mortgage banks are able to issue mortgage bonds. In the Czech Republic and the Slovak Republic, only universal banks with a special license for issuing mortgage bonds do so. Mortgage conduit is a company or entity that mainly redeems mortgage loans from commercial banks and/or non-banks for securitisation, which is mostly a state-owned company or the government sponsored enterprise (GSE) such as *Fannie Mae* in the U.S. The conduit basically does not conduct direct mortgage lending and functions as a liquidity institution between the primary and secondary market. Latvia and Kazakhstan have this type of structure (the Mortgage and Land Bank of Latvia and the Kazakhstan Mortgage Company).

The number of issuers (2-8 issuers) is not few as compared to the advanced European countries as shown in Figure 15. Germany and Spain have double digits of issuers but other European countries generally have only 2-8 issuers.

Selected countries' conditions are overviewed as follows:

Figure 15: Mortgage Bond Issuers



(Source) Transition Economies: OECD Market Survey on Housing Finance 2004 (data in June 2004, CZ: 2003)
EU&CH: European Mortgage Federation (data in 2002)

In Poland, three mortgage banks have issued mortgage bonds, where Reheinhyp-BRE accounted for 94% of the total issuance in 2003 (HypoVereinsbank: 5%; Slaski: 1%). Recently, HypoVereinsbank and Reheinhyp-BRE have changed their names to BPH Mortgage Bank (Nov. 2004) and BRE Mortgage Bank (Jan. 2005) respectively. Private issuance accounts for the majority, but since 2002 public issuance also has been possible.

In Hungary, three mortgage banks have dominated the covered bond market: OTP Mortgage bank (64% market share), FHB (31%) and HVB Mortgage Bank (5%). Private placement is the major way to issue bonds for mortgage banks. Public issuance at the Budapest Stock Exchange is relatively small in scale (average size of issuance is EUR50-70 million). In this context, the three mortgage banks have different issuance practices: 1) OTP Mortgage Bank, following the OTP Group's intention, has partially shifted to public issues and its first international issue is under preparation; 2) FHB has gradually shifted to public issues and has carried out international issues since 2003; and 3) HVB Mortgage Bank has issued mortgage bonds at the "mother (private placement)", only focusing on domestic sales. Currently, OTP Mortgage Bank and FHB have obtained A1 rating of covered bonds by Moody's (in June 2004 and in 2002 respectively) but HVB Mortgage Bank has yet to obtain a rating. Mortgage banks basically refinance mortgage loans by two ways: 1) purchasing mortgage loans from commercial banks based on the independent lien sales contracts or the syndicated loan agreement; and 2) using their own mortgage loans as cover assets. For this reference, there is a rule that subsidised loans must be financed by mortgage bonds. Therefore, commercial banks must make use of mortgage banks' refinancing schemes to qualify for the government subsidies.

2-2-6. Investors Structure

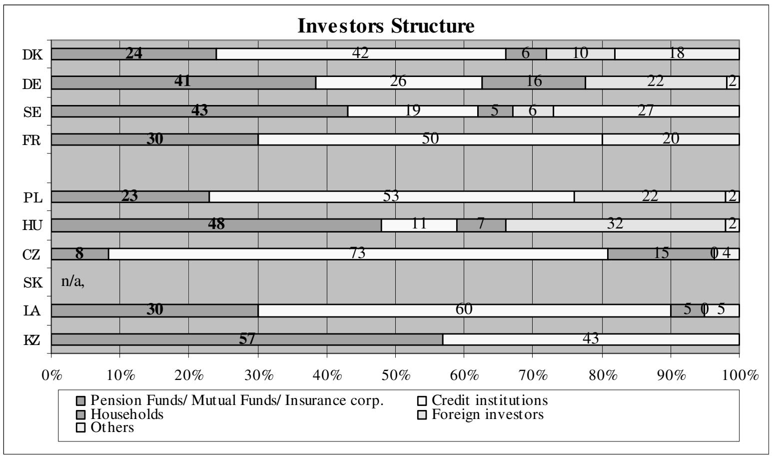
It is possible to some extent to conjecture the attractiveness of the mortgage bond market based on the investors' structure. As shown in Figure 16, institutional investors such as pension funds, mutual funds and insurance companies account for a large portion of investors in the advanced European countries (roughly one third of the total investors). Study countries also tend to follow the same trend. In Hungary, almost half of investors are domestic institutional investors (pension funds, investment funds and insurance companies; 48% in 2003). Also in Kazakhstan, over the half are pension funds (53% in 2004). In Latvia, insurance companies and pension funds account for around 30% (2003).

In Poland, domestic institutional investors (trust funds and insurance companies) had held the second position in the covered bond market (23% in 2002), which followed commercial banks, but recently their share has been decreasing (particularly, insurance company: 2% during Jan.-Nov. 2004). Against this background, there seem to be statutory investment limits for institutional investors. According to the rules, investors' participation in the market is restricted as follows: 1) insurance companies: max. 40% of funds; 2) investment funds: max. 80% of funds; and 3) pension funds: max. 30% of funds. By contrast, there is no investment limits to mortgage bonds for banks.

Foreign investors are also a growing segment of the market. In Poland, foreign investors have increased their share more than 46% in 2004 (from 22% in 2002). In Hungary, foreign investors have become the largest segment of investors, which account for one third of the investors (32% in 2003). According to Hungarian authorities, the growth of foreign investors would be attributed to Moody's rating of Hungarian covered bonds but the recently introduced investment limits for institutional investors (in 2004) might influence some investors.

In study countries, except for Hungary and Kazakhstan, commercial banks are the largest investor group (over half of investors). In Hungary, commercial banks have become a relatively small investor group because they face some limits regarding the purchase of long-term assets. Consequently, cultivating institutional investors and foreign investors will be important for the mortgage bond markets in these countries to be active.

Figure 16: Mortgage Bond Investors

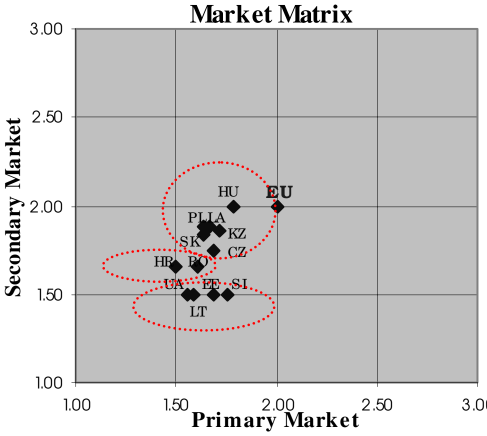


(Source) Transition Economies: OECD Market Survey on Housing Finance 2004 (data in 2003)
EU: European Mortgage Federation (data in 2002, DE&SE: 1998)

2-3. Country Assessments

Taking account of the above mentioned issues, similar to the housing market analyses in chapter 1, the current performance of housing finance markets in transition economies was assessed in terms of the primary and secondary markets. Figure 17 indicates the aggregate result from Table 4:

Figure 17: Primary and Secondary Market Matrix



PL	Poland
HU	Hungary
CZ	Czech Republic
SK	Slovak Republic
LT	Lithuania
LA	Latvia
EE	Estonia
SI	Slovenia
HR	Croatia
RO	Romania
UA	Ukraine
KZ	Kazakhstan

From Figure 17, the current performance of primary and secondary markets in study countries can be analysed as follows:

- Group 1 (new EU members) with the secondary mortgage market plus Kazakhstan from Group 3 (CIS) have formed a group approaching the EU level. Although their primary and secondary markets are still small in scale, they are clearly in a transition process from deposit based to market based lending. Among them, Hungary has most rapidly developed both primary and secondary mortgage market. In this area, specialised mortgage banks have taken a significant role of activating the Hungarian market.

- Group 2 (EU candidates) has made the second group in the matrix. Although their lending volume is very small and they have no secondary mortgage market, their market potential based on the contract savings schemes is positively evaluated. However, it would be worth considering the introduction of secondary market funding in order to realise customer based just-in-time lending with risk control.

- Group 1 with no secondary market and Ukraine from Group 3 have formed the third group in the matrix. Their mortgage lending has been sharply growing recently but the source of capital for housing loans tends to be still mostly banks' short-term deposits, where mortgages as collateral seem not to be effectively used. Also, it will be worth considering the introduction of secondary market funding in those countries.

Table 4: Primary and Secondary Market – Country Assessment Sheet

		PL	HU	CZ	SK	LT	LA	EE	SI	HR	RO	UA	KZ
Primary (Lending) Market	**Market Scale & Potential**												
	- Housing loans outstanding	1	1	1	1	1	1	1	1	1	1	1	1
	- Share of housing loans to GDP	1	1	1	1	1	1+	1+	1	1	1	1	1
	- Share of mortgage lending to the total housing loan market	1+	2+	2-	1+	n/a,	1+	3-	2-	1+	n/a,	1+	3-
	- Mortgage lending growth	2-	2-	2+	3	n/a,	3	2	3	2-	2+	2-	3
	Mortgage Products												
	- Mortgage products without subsidies	2-	2-	1+	1+	2-	2	2-	2-	2-	2-	1+	2
	- Interest rate	2	2	2	2	2	2	2	2	2	2	2	2
	- Loan term	2	2	2	2	2	2	2	2	2	2	2	2
	- Loan-to-value ratio (LTV)	2+	2+	2+	2+	2+	2+	2+	2+	2+	2+	2+	2+
	Lending Structure												
	- Number of lenders (openness of the market/ not oligopolistic)	1+	1+	1+	1+	n/a,	2-	1+	2-	2-	1+	1+	2-
	- Private lenders (not state owned/state controlled lenders)	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-
	- Foreign lenders	2+	2+	2-	2-	2-	2-	2-	2-	1+	1+	1+	1+
	- Market share of specialised mortgage lending institutions	1+	2+	1	1	1	1	1	1	1	1+	1	1
	- Ratio of mortgage debts originated by mortgage banks	1+	2+	1	1	1	1	1	1	1	1+	1	1
	- Ratio of housing loans to the total assets (commercial banks)	1+	2-	3	n/a,	n/a,	2-	2+	2+	1+	n/a,	3	2-
	- Borrowers: individual households	2	2	2	2	2	2	2	2	2	2	2	2
	- National Housing Funds (public supports)	2	1	2-	2	2-	1	1	2	1	1+	1	1
Average Performance (sum of scores divided by the number of items)		2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-
Secondary (Funding) Market	**Funding Instruments**												
	- Securitisation schemes (mortgage covered bonds/ MBS)	2	3-	2	2	1	2	1	1	1	1	1	3-
	- Deposits (short-term deposits/ CSS)	2	1	2+	2	2	2	2	2	2+	2+	2	1
	Market Scale & Potential												
	- Mortgage bonds outstanding	1+	1	1+	1	n/a,	1	n/a,	n/a,	n/a,	n/a,	n/a,	1
	- Share of mortgage bonds to GDP	1	1+	1+	1	n/a,	1	n/a,	n/a,	n/a,	n/a,	n/a,	1
	- Share of mortgage bonds to mortgage debts	1+	2	2	2	n/a,	1+	n/a,	n/a,	n/a,	n/a,	n/a,	1+
	- Mortgage bonds growth (growth potential)	2-	2	1+	2	n/a,	3-	n/a,	n/a,	n/a,	n/a,	n/a,	3
	Mortgage Bond Products												
	- Type of bonds	2	2	2	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	2
	- Interest rate	2+	2+	2	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	2+
	- Maturity	2	2	2-	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
	- LTV limit for cover assets	2	2	2	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
	Mortgage Bond System												
	- Protection by laws	2	2	2	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	2
	- Bankruptcy privilege for creditors	2	2	2	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
	- Funding flexibility (substitute collateral)	2	2	2	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
	- Cover register	2	2	2	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
	- UCITS Directives (fulfilled: 2 or not: 1)	2	2	2	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
	Issures Structure												
	- Mortgage banks/ mortgage conduit	2	2	1	1	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	2
	- Number of issuers	2	2	2	2+	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	2
	Investors Structure												
	- Institutional investors	2-	3	1+	n/a,	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	3
	- Foreign investors	3-	3	1	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,	1
	- Number of investors	2-	2-	2-	2-	n/a,	2-	n/a,	n/a,	n/a,	n/a,	n/a,	2-
Average Performance (sum of scores divided by the number of items)		2-	2	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-

(Note) All analyses in chapter 2 have been translated into country assessment sheet in Table 4, where each condition influential in the mortgage market was rated from 1 (relatively low performance) to 3 (relatively high performance) as compared to the EU level and/or the advanced EU countries. In the definition, the rating is classified into seven categories: 1: much worse than EU; 1+: worse than EU; 2-: slightly worse; 2: EU level; 2+: slightly better than EU; 3-: better than EU; and 3: much better than EU. To calculate the average performance in each country, 0.3 point is given to "+" and deducted from original point in "-" for convenience sake. Because of the difficulty in standardising all the figures, the performance in study countries is subjectively rated in comparison with one another, the EU average and/or the advanced EU countries.

3. Regulation and Housing Policy

Well-organised regulatory and supervisory frameworks are indispensable if countries are to gain the maximum benefits from housing finance markets. Due to the complexity of mortgage-related products, establishing accepted standards of regulations for the overall mortgage market is crucial for vitalising the housing finance markets in the region. A proactive approach of regulation with transparency is also very important for establishing sustainable sound housing finance markets in study countries. In this context, the following four aspects are examined: 1) domestic legal infrastructure; 2) compliance with the EU standards and rules; 3) compliance with international standards (e.g. Basel, IAIS, IOSCO, IMF and OECD principles, etc.); and 4) progress of the financial sector reform in study countries.

3-1. Regulatory Structure

Regulators and Supervisors

Mortgage lending is basically a part of the banking system in the region. Therefore, the Ministry of Finance, the Financial Supervisory Agency and the Central Bank are core regulators and supervisors of the housing finance market. As a supervisor of the secondary mortgage market, a trustee also plays a substantial role in supervising mortgage bank's activities. Poland, Hungary and the Slovak Republic make use of a trustee to supervise and monitor cover assets of mortgage bonds. In Poland, the Commission for Banking Supervision appoints a trustee and a deputy trustee. A trustee is responsible for checking the regular security of mortgage bonds and their adequate cover, to control the mortgage cover register, and to conduct on-site examinations in the mortgage banks. In Hungary, each mortgage bank appoints a trustee as an asset supervisor with the approval of the Financial Supervisory Authority. Only a certified public accountant or a resident natural person can become a trustee, whose responsibility is to permanently monitor and certify adequate cover assets of mortgage bonds and the entry of cover assets into the cover register. In the Slovak Republic, the National Bank of Slovakia appoints a trustee and a deputy trustee (which is called "mortgage controller") to each bank for supervising the issuance of mortgage bonds and municipal bonds and for monitoring bank's activities regarding mortgage bonds.

In Kazakhstan, the Financial Supervision Authority (FSA) was newly established as a single regulator of the financial market in January 2004, separating from the National Bank of Kazakhstan. The FSA regulates and supervises both primary and secondary mortgage market in Kazakhstan.

Legal Frameworks for Mortgage Lending and Funding

The basic legal infrastructure is relatively well established in study countries. For countries having a secondary mortgage market, the Acts on mortgage banks and mortgage bonds have been well developed since 1995. These laws are basically modelled on the German Mortgage Bank Act ("*hypothekenbankgesetz*"). These developments may reflect efforts on the part of the German building societies to promote their own housing finance system in neighbouring countries. In fact, some of the study countries have contract savings schemes similar to the German *Bausparkassen* system and mortgage covered bond schemes similar to its *Pfandbrief*. Before those Acts appeared, a mortgage lending system had already existed in the socialist economy but it was not so important for the centrally planned economy at that time. When the transition economies became independent and began to move toward a market economy in the early 1990s, existing regulatory frameworks for mortgage lending were abolished and for a time there was no substantial legal framework on mortgage lending in the region.

Table 5: Regulators and Supervisors

	Name of Organisation	Housing Finance Market		Housing Market
		Primary	Secondary	(Housing policy)
Poland	Ministry of Finance	✔	✔	
	National Bank of Poland	✔	✔	
	Commission for Banking Supervision	✔	✔	
	Polish Bank Association	✔ (SRO)		
	Polish Securities and Exchange Commission		✔	
	Insurance and Pension Funds Supervisory Commission		✔	
	Trustee		✔	
	Ministry of Infrastructure			✔
Hungary	Ministry of Finance	✔	✔	
	Hungarian Financial Supervisory Authority	✔	✔	
	National Bank of Hungary (Magyer Nemzeti Bank)	✔	✔	
	Trustee		✔	
	Ministry of Interior			✔
	Ministry of Economic Affairs			✔
Czech Republic	Ministry of Finance	✔	✔	
	Czech National Bank	✔ (licensing)	✔	
	Czech Mortgage Bank Committee	✔		
	Czech association of Banks	✔ (SRO)		
	Czech Securities Commission		✔	
	Ministry of Regional Development			✔
Slovak Republic	Ministry of Finance	✔	✔	
	National Bank of Slovakia	✔ (licensing)	✔	
	Trustee		✔	
	Ministry of Construction and Regional Development			✔
Lithuania	Ministry of Finance (Central Project Management Agency)	✔		
	Bank of Lithuania	✔		
	Ministry of Economies			✔
Latvia	Ministry of Finance	✔	✔	
	Financial and Capital market Commission	✔	✔	
	Bank of Latvia	✔		
	Ministry of Regional Development	✔		✔
Estonia	Ministry of Finance	✔		
	Financial Supervision Authority	✔		
	Bank of Estonia	✔		
	Ministry of Economic Affairs			✔
Slovenia	Ministry of Finance	✔		
	Ministry of the Environment, Spatial Planning and Energy			✔
Croatia	Central National Bank	✔		
	Ministry of Finance	✔		
	Money-Laundering Prevention Office	✔		
	Deposit Insurance and Bank Rehabilitation Agency	✔		
Romania	Ministry of Public Finance	✔		
	National Bank of Romania	✔		
	Ministry of Transport, Construction and Tourism			✔
Ukraine	National Bank of Ukraine	✔		
	State Commission on Regulation of the Financial Market	✔		
	State Commission on Securities and Stock Market	✔		
Kazakhstan	Financial Supervision Authority of Kazakhstan	✔	✔	

(Source) OECD Market Survey on Housing Finance 2004

In Poland, Hungary, the Czech Republic, the Slovak Republic and Latvia, the Acts on mortgage banks and mortgage bonds provide market participants with the basic standards regarding both primary and secondary mortgage markets: 1) prudential rule for assessing the lending value; 2) LTV limit to refinance mortgage loans via the issuance of mortgage bonds; 3) bankruptcy privilege for mortgage bond creditors; and 4) mortgage ranking improvement for the foreclosure process (i.e. generally, mortgages as cover assets of mortgage bonds are granted higher ranking than normal mortgages, which often enjoy favourable tax treatment). These Acts have fulfilled the criteria of the European minimum standards for mortgage bonds, particularly Article 22 (4) of the UCITS directive. Therefore, the countries have a similar legal framework for mortgage lending and covered bonds. The few remaining differences among these countries are 1) there is no principle of specialised mortgage lending institution in the Czech Republic, the Slovak Republic and Latvia (i.e. they have no specialised mortgage banks) and 2) there are legal provisions of mortgage-backed securities (MBS) in addition to mortgage covered bonds in Poland.

In Kazakhstan, the legal infrastructure on housing and mortgage finance has been developed since 1991. Particularly, since the Kazakhstan Mortgage Company was established in December 2000 as an entity similar to the GSE in the U.S., the legal framework on mortgage lending and mortgage bonds has been well organised.

Study countries, except for Kazakhstan, have no laws and regulations on mortgage default insurers at this moment.

Table 6: Legal Framework

	PL	HU	CZ	SK	LT	LA	EE	SI	HR	RO	UA	KZ
Mortgage laws and related regulations (to ensure property (real estate) as a mortgage)	Y	Y	Y	Y	Y	Y	Y	Y	N	Y	Y	Y
Laws and regulations on property registration (to make sure of property rights for owners)	Y	Y	Y	Y	n/a,	Y	Y	Y	Y	Y	Y	Y
Laws and regulations on specialised mortgage lending institutions (mortgage banks) (principle of specialised bank)	Y	Y	N	N	N	N	N	N	N	Y	N	Y
Laws and regulations on depository (savings) institutions	Y	Y	Y	Y	N	Y	N	Y	Y	Y	Y	Y
Laws and regulations on private mortgage insurers	N	N	N	N	N	N	N	N	N	N	N	Y
Laws and regulations on secondary mortgage facilities (MBS)	Y	N	N	N	N	N	N	N	N	N	N	Y
Laws and regulations on transactions of mortgage bonds (mortgage covered bonds)	Y	Y	Y	Y	N	Y	N	N	N	N	N	Y
Foreclosure laws and related regulations	Y	Y	Y	N	n/a,	Y	Y	Y	Y	Y	Y	Y
Others	n/a,	n/a,	n/a,	n/a,	n/a,	Y	n/a,	n/a,	Y	n/a,	n/a,	n/a,

(Source) OECD Market Survey on Housing Finance 2004 (data in 2004, LT: 2002) * Y: Yes, N: No

Compliance with the EU Standards and Rules

New EU members (Group 1) have an obligation to fulfil the European Union banking legislation. EU candidates (Group 2) also must do so in due course. The main provisions related to mortgage banks and mortgage bonds consist of five core groups of directives: 1) the first and second directives on the co-ordination of banking legislation: core principles of banking sector activities, which cover mortgage bank's activities; 2) the solvency ratio and large exposure directives: common standards for the adequacy of own funds of credit institutions and for large exposures of credit institutions to avoid the excessive concentration of credits on a single customer in terms of the active competition; 3) the directives on investment firms: rules on capital adequacy of investment firms and credit institutions; 4) the third directive on life and non-life insurance: liberalisation and harmonisation of life assurance and non-life insurance; and 5) the UCITS directive: the standard on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investments in transferable securities.

Special treatment of highly secured bonds was first introduced in the EU legislation in 1988, namely, UCITS directive. The purpose was to allow investment funds to concentrate their funds on a group of highly secured bonds. An investment fund may invest in highly secured bonds issued by one issuer by maximum 25% of its asset (by maximum 5% for other securities). This regulation is particularly important for countries using capital market funding for mortgage lending. Bonds, as defined in the Article 22 (4) of the UCITS directive, are required to fulfil the following minimum standards:

- The bonds must be issued by a credit institution, which is subject to the law on special public supervision to protect bondholders;

- The proceeds from the sales of bonds must be invested in assets that are able to cover claims attached to bonds during the lifetime of bonds, in conformity with the law; and

- In the event of bankruptcy, the bondholder has a privileged access to the assets funded by the bonds.

The similar EU legislation has been passed given wider access for insurance companies to hold UCITS defined bonds in their technical reserves. In the EU banking legislation, the directive on solvency ratio allows member states to introduce 10% risk weight for highly secured bonds (20% risk weight for other claims on banks). The term "covered bonds" was not used in those directives but European supervisors have now broadly accepted this term. Currently, the term "covered bonds" has appeared in the proposal for amending the capital requirements directive (CRD), which the European Commission presented in July 2004 in parallel with the new Basel II agreement. The CRD proposal gives a definition of covered bonds, which refers to the Article 22 (4) of the UCITS directive, but goes into some details defining the eligible assets for covered bonds.

As already mentioned, Poland, Hungary, the Czech Republic, the Slovak Republic and Latvia have reflected the Article 22 (4) of the UCITS directive in their national legislation. So far, they have successfully incorporated the EU standards and rules into their laws and regulations on mortgage markets.

Compliance with International Standards

Under the recent trend of globalisation, especially the evolution towards a single mortgage market in the EU, the compliance with international standards is critical for study countries to vitalise their markets. In this context, core international principles will be; 1) Basel Core Principles for Effective Banking Supervision (BCP); 2) IAIS Insurance Core Principles (ICP); 3) IOSCO Objectives and Principles for Securities Regulation (SCP); 4) IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFP); 5) OECD Principles on Corporate Governance (OCG); and 6) International Accounting and Auditing Standards (IAS). According to the financial sector assessment program (FSAP) initiated by the World Bank and the IMF, the compliance level with those international principles seems not to be sufficient yet in study countries (Table 7).

Table 7: Compliance with International Standards on Regulations and Supervision in Selected Countries

	Basel BCP	IAIS ICP	IOSCO SCP	IMF MFP	OECD OCG	IAS
Poland	△ - consolidated financial reporting is overdue, etc.	△ - more inspections, adequate powers to intervene weak companies, etc.	○ - almost compliance	○ - good transparency practices	△ - need regulatory tools to hold management boards	△ - deficiencies still exist (not fully cover all financial products
Hungary	△ - lack legal backing for supervisors	△ - need more risk-based approach	○ - Capital market Act complies with most of SCP	○ - almost compliance with NBH Act	n/a,	n/a,
Czech Republic	△ - need more capital adequacy for credit in banks, etc.	△ - supervision office lacks independence, etc.	△ - practical limitation, lack of human resources, etc.	○ - good transparency practices of banking supervision	△ - lack of strong creditor rights, etc	○ - auditing standards comply with IAS
Slovak Republic	○ - strengthened banking regulation by new law (2002)	△ - supervisor needs additional human resource, etc.	△ - insufficient issuers information, etc.	○ -satisfy high standard of transparency of banking supervision	△ - not fully protected minority shareholder, etc.	△ - little compliance, own accounting standards

(Source) own estimate from FSAP reports in respective countries; PL: June 2001, HU: June 2002, CZ: July 2002, SK: Jan. 2003 & Sept. 2002

○: basically compliance △: limited (need further improvements)

Although these countries have improved their financial sector regulations and supervision, they still have shortcomings to be improved in banking, insurance, securities regulatory schemes and corporate governance. However, transparency in monetary and financial policies already has been highly improved in the region (e.g. via annual report). Furthermore, the EBRD has recently assessed the level of compliance with international insolvency standards in its Legal Indicator Survey 2004, where 1) Lithuania and Ukraine registered a very low compliance (inadequate legal provisions); 2) Hungary, Latvia and Slovenia registered a low compliance (poor treatment of creditors); 3) Poland, the Czech Republic, the Slovak Republic, Estonia and Kazakhstan registered a medium compliance (interim protection of debtors, etc.); and 4) Croatia and Romania registered a high compliance (relatively clear legislation). Also, it should be noted that the new international Basel Capital Accord (Basel II) is supposed to come into force by the end of 2006. Basel II specifies minimum capital requirements, the supervisory review of capital adequacy and the public disclosure. Based on the Basel II, the European Commission introduced 35% risk weight for lending fully secured by mortgages on residential property and is considering 50% risk weight on commercial property. As Basel II will be reflected in the EU directive on capital requirements, study countries, except for Ukraine and Kazakhstan, must implement it in due course.

Progress of the Financial Sector Reform

According to the EBRD, study countries have been progressing with their banking sector and securities market reforms. In the Czech Republic, the introduction of a new collective investment law (enacted in May 2004) and the first successful IPO of a domestic company (Zentiva, leading pharmaceutical company) raised its ranking upward. In the Slovak Republic, growing competition in the banking sector and the improved credit quality were positively evaluated. Also in Estonia, Romania and Croatia, the growth of credit to the private sector was well evaluated (Table 8).

Table 8: Financial Sector Reform

	Governance & enterprise restructuring [a]	Competition policy [b]	Banking reform & interest rate liberalisation [c]	Securities markets & non-bank financial institutions [d]
Poland	3+	3	3+	4-
Hungary	3+	3	4	4-
Czech Republic	3+	3	4-	3+
Slovak Republic	3	3	4-	3-
Lithuania	3	3	3	3
Latvia	3	3-	4-	3
Estonia	3+	3-	4	3+
Slovenia	3	3-	3+	3-
Croatia	3	2+	4	3-
Romania	2	2+	3	2
Ukraine	2	2+	2+	2+
Kazakhstan	2	2	3	2+

(Source) EBRD Transition Report 2004

[a] 2: moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance; 3: significant and sustained actions to harden budget constraints and to promote corporate governance effectively

[b] 2: competition policy legislation and institution set up; some reduction of entry restrictions or enforcement action on dominant firms; 3: some enforcement actions to reduce abuse of market power and to promote a competitive environment

[c] 2: significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings; 3: substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; 4: significant movement of banking laws and regulations towards BIS standards

[d] 2: Formation of securities exchanges, market makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities; 3: substantial issuance of securities by private enterprises; 4: securities laws and regulations approaching IOSCO standards

3-2. Housing Policy

There are several government support measures in study countries as well as in the advanced EU countries. Table 9 shows a comparison of housing policy in Central Europe and the selected EU countries, and the major government programs in the selected study countries, which are subdivided into further detailed programs in practice. Most housing policies in study countries, except for Latvia and Kazakhstan, are closely linked to the government subsidy. In general, housing policy in the region can be classified into the following four categories: 1) government support measures for homeownership; 2) government support measures for rental housing; 3) preferential housing taxation; and 4) urban development and other social policies.

Housing Policy for Homeownership

The core housing policy for homeownership is two-fold: 1) interest payment subsidy for housing construction, purchase, renovation or enlargement and 2) guaranteed bonus on savings for housing purpose. Study countries, except for Latvia and Kazakhstan, have one of those systems or both, which are subsidised by the government.

The interest rate subsidy is the scheme by which the government grants an amount covering the excess of the mortgage interest rate over the market rate, which enables households to enjoy a relatively low fixed-rate long-term housing loan. Although this scheme usually sets a ceiling on the subsidy amount (e.g. max. 2.5 million SKK per unit in the Slovak Republic) or the interest rate limit of housing loans (e.g. 6% in Hungary), it may seriously bloat the national budget if inflation rates continue to rise. For this reason, the Polish program is to be terminated in 2005.

The guaranteed bonus on savings is the premium granted by the government to home-savings-account holders in the framework of contract savings schemes (e.g. 25% of the deposit per annum in the Czech Republic, 15% in the Slovak Republic), which is basically modelled on the German *Bausparkassen* system. A major problem with this scheme is that the large portion of savings has not been used for housing purpose (e.g. only 40% of savings are used for housing investments in Poland). The premium rate has been gradually decreasing recently.

In the advanced EU countries, those schemes tended to be abolished because of the budgetary concern. In transition economies, the initial purpose of government policy for encouraging homeownership was mainly to promote housing privatisation, to stimulate housing construction and to improve the quality of housing stocks. The first aim has been well achieved in the region. The second aim should be left to the market taking into consideration the current transition stage to the market economy in the region. The third aim still might be in the government initiative.

Housing Policy for Rental Housing

An important purpose of the government policy for rental housing will be to offer social supports for socially disadvantageous groups (i.e. low income households, the disabled and retired individuals) by means of the construction and repair of rental housing. In general, municipalities are responsible for this purpose. Therefore, the government often subsidises municipalities (e.g. financial supports for the construction of municipal rental apartments and technical infrastructure in the Czech Republic). To this end, the National Housing Fund has been established based on housing privatisation revenues in some of study countries. Thanks to this scheme, municipalities are able to make use of low interest rate credits (e.g. interest-free government loans for municipalities through the State Housing Development Funds in the Czech Republic). Although this scheme plays a supportive role in vitalising the housing finance market, it raises the risk of accelerating the national budget deficit and impeding sound competition in the market. One unique example is the bank guarantee scheme on loans for housing construction in the Slovak Republic, which has prioritised the rental housing construction for socially disadvantageous groups but the national budget has not been introduced in this program (its operations are the bank's responsibility: the Slovak Guarantee and Development Bank implemented this program in 2004).

Preferential Housing Taxation

The preferential tax treatment for housing purpose is an important scheme for enhancing households' access to housing finance and the liquidity of the housing market. Study countries have several types of tax relief and tax exemption schemes: e.g. personal income tax relief/exemption; preferential value added tax rate for home acquisition, selling and renovation; income tax exemption for social housing associations and housing cooperatives; tax exemption on capital gains from mortgage covered bonds, etc. Those tax treatments will be effective to activate the housing and housing finance market in the region, but can impact the government revenue. In Poland, the tax relief was abolished in 2002.

Urban Development and Other Social Policies

Several urban development and social policies have functioned as supplementary measures. For example, Hungary and the Czech Republic have provided special financial support for targeted households: i.e. interest-rate support for young couples and families with three or more children only for new housing construction or purchase in Hungary; financial support for the acquisition of older dwellings for persons younger than 36 years old in the Czech Republic. As well, Hungary and the Czech Republic have prepared financial support for housing reconstruction in case of natural disasters. Thus, some of the countries have adopted wide-ranging subsidy programs for housing purpose.

Table 9: Housing Policy in Selected Countries

	Housing Policy for Homeownership	Housing Policy for Rental Housing	Preferential Housing Taxation
4CE	- Interest payment subsidy PL: to be terminated in 2005 - Guaranteed bonus on savings CZ: 25% of deposits, SK: 15% [Problem] large portion of savings are not used for housing purpose PL: only 40% of savings are used for housing investments	Social supports for low-income households, the disabled and retired individuals - Financial support for rental housing construction - Budgetary support for municipalities PL: National Housing Fund - Housing allowance	- Personal income tax relief / exemption; - Preferential value added tax rate for home acquisition, selling and renovation; - Income tax exemption for social housing associations and housing cooperatives; - Tax exemption on capital gains from mortgage covered bonds (SK), etc.
UK	- Preferential sales of public housing ("Right to Buy") - Preferential loan program for low-income households by municipalities ("Mortgage Interest Relief at Source (MIRAS)": abolished in Apr. 2000)	- Housing allowance	- Preferential value added tax & stamp duty for home acquisition, etc.
DE	- Subsidy on home acquisition (since 1996; term – 8y) (Mortgage interest rate relief: abolished in 1996) - Guaranteed bonus on savings ("Bausparförderung") - Preferential loan program for low-income households by municipalities	- Financial support for rental housing construction ("Bausparförderung") - Housing allowance ("Wohngeld")	- Income tax exemption for pre-acquisition costs of housing, etc.
FR	- Interest payment subsidy ("prêt à taux zero, PTZ ; interest rate burden zero% for low-& middle-income households, loan equivalent to max. 20% of property value) (Mortgage interest rate relief: abolished in 1996) - Guaranteed bonus on savings (PEL) - Subsidy on home improvement for low-income households (PAH)	- Financial support for rental housing construction ("prêt locatif aide, PLA) - Housing allowance (AL, APL)	- Preferential value added tax - Property tax relief, etc.

(Source) 4CE (Poland, Hungary, Czech Rep. and Slovak Rep.): *OECD Market Survey on Housing Finance 2004*

UK, DE (Germany) and FR (France): interpreted the data from "*Kaigai Jutakukinyu Kenkyukai, Japan (May 2000)*"

Poland	**Housing Policy for Homeownership**	
	Interest payment subsidy (low fixed rate long-term loan for housing construction, purchase and renovation)	Payment of an interest rate over the market rate Law on Fixed Interest Housing Loan Program is terminated in 2005.
	Guaranteed bonuses on savings (individuals)	Guaranteed premiums for depositors in case of deposit for housing purpose. 40% of savings are used in housing investments. Law on state Support in Repayment of Selected housing Loans, Refunding to Banks Guaranteed Bonuses
	Tax relief / tax exemption	Income tax relief (Law on Personal Income Tax); Preferential VAT (value added tax) rate for home acquisition, selling and renovation
	Housing Policy for Rental Housing	
	National Housing Funds (explained in Chapter 2)	Law on Selected Forms of Housing Support
	Guarantees bonuses on savings (corporations)	See above.
	Housing allowances	Introduced in 1994. Municipalities' support for low-income segment. Gov. subsidies have been withheld since 2004. Law on Housing Allowances
	Tax exemptions for social housing associations (SHA)	Temporary measure (till the end of 2006) SHA are exempted for tax only under the condition that its revenues are directed to statutory activities. Law on Corporate Income Tax
	Urban Development Policy	
	Technical infrastructure loans	Loans for technical infrastructure related to housing construction are granted under similar conditions as loans granted to SHA.
Hungary	**Housing Policy for Homeownership**	
	Interest payment subsidy (low fixed rate long-term loan for new housing construction and purchase)	Payment of an interest rate over the market rate The sum of interest rate and service charges paid by the client is limited in 6% ; not permanent measure
	Preferential interest payment support for a preferential social group	Interest rate support for young couples and families with 3 or more families. New housing construction or purchase only
	General interest payment support	Anyone can apply. Housing purchase, renovation or enlargement can be applicable.
	Guaranteed bonuses on savings	Home savings account holders or beneficiaries are eligible for the state subsidies. Provided via Home Savings and Loan Association Mortgage rate must be ≦10%; New deposits on savings accounts by 30% with a ceiling.
	Tax relief	VAT; personal income tax relief
	Housing Policy for Rental Housing	
	Rental housing construction program	Joint financing with municipalities for the reconstruction of blocks of flats and apartment houses.
	Social Policy	
	Preferential interest rate credit lines	For modernising heating systems For owners of dwellings in blocks of flats
	Financial support to the adaptation of housing for the disabled	n/a,
	Financial support to the reconstruction in case of natural disasters	n/a,
Czech Republic	**Housing Policy for Homeownership**	
	Interest payment subsidy on mortgage loans	Available only for the purchases of new dwellings
	Financial support for the acquisition of older dwellings for a preferential social group	State support for persons younger than 36 years old
	Guaranteed bonuses on savings	Savings bonuses for home savings account holders 25% of the deposits per annum
	Subsidy on repair of housing stocks	For all owners (private owners, municipalities, housing co-operatives and legal entities
	Subsidy on down payment	n/a,
	Tax relief / tax exemption	Income tax exemption on interest revenues from mortgage certificates, etc.
	Housing Policy for Rental Housing	
	Financial support for construction of municipal rental apartments and technical infrastructure	Rental housing construction for persons in a specific income bracket (low income segments)
	Financial support for construction of rental housing with community case services	For the disabled and retired individuals
	Financial support for repair of defects of prefabricated panel building	The same program as subsidy on repair on housing stocks
	Interest-free government loan for municipalities	Interest-free and repayable within up to 10-year Low interest credits granted by the State Housing Development Funds
	Housing allowances	n/a,
	Social Policy	
	Financial support to the reconstruction in case of natural disasters	(Flood)
	Subsidy for heating insulation	n/a,

Slovak Republic	**Housing Policy for Homeownership**	
	Interest payment subsidy on mortgage loans ("government bonus")	Government bonus to a mortgagor (property owner) Granted only upon mortgage loan contract Max.2.5 mil. SKK per unit
	Guaranteed bonuses on savings ("government bonus")	Savings bonuses for home savings account holders 15% of the deposits per annum
	Tax relief / tax exemption	Property tax exemption (5-10 years) Personal income tax exemption, etc.
	Housing Policy for Rental Housing	
	Subsidy on the acquisition of rental flats for residents with low income	n/a,
	Subsidy on the remedy of damages of blocks of flats built using the panel technology	n/a,
	Bank guarantees on loans for housing construction	Priority: rental housing construction for socially disadvantageous groups (low-income segments) No state budget introduced. The Slovak Guarantee and Development Bank implemented this program in 2004.
	Tax relief / tax exemption	Income tax exemption for housing cooperatives
	Other Policy	
	Tax exemption on capital gains from mortgage covered bonds	n/a,

(Source) OECD Market Survey on Housing Finance 2004

Hereby a few questions arise: how much has the government been spending for housing policy and whether or not government support measures for housing have been bloating the national budget severely. Table 10 shows a comparison of the total cost of government support measures for housing with government spending for other social policies in study countries. Around 1-7% of the national budget has been spent for government measures for housing purpose in the region, which accounts for less than 1% of GDP except for Romania (2%). In comparison, as examples of other social policies, education and health care policies have accounted for much more of the budget, either of which accounted for more than 10% of the national budget and around 4% or more of GDP in Hungary and Romania. That spending amounted to more than 10% of GDP in Hungary (2003). From this fact, it seems that government subsidies for housing purpose have not bloated the national budget at present as compared to other types of government spending. However, wide-ranging subsidy-scatter will not be cost efficient (e.g. savings bonus subsidy ineffective in some case). Taking account of their current transition stage to market-based economies, it may be necessary that government subsidy programs be more focused as regards housing demand (market demand) and that unfocused and costly subsidy programs be reformed appropriately.

Table 10: Government Subsidies and Other Government Spending

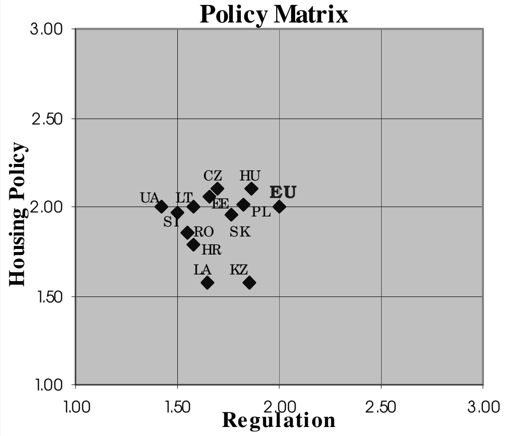
			PL	HU	CZ	SK	LT	LA	EE	SI	HR	RO	UA	KZ
Interest bonuses on savings			Y	Y	Y	Y	N	N	Y	Y	Y	Y	N	N
Subsidies on interest payments on mortgage loans			Y	Y	Y	Y	Y	N	Y	n/a,	N	N	Y	N
Personal income tax benefits			Y	Y	Y	N	Y	N	Y	n/a,	Y	N	Y	N
Down payment subsidies			N	N	Y	N	Y	N	N	n/a,	Y	N	Y	N
Construction subsidies			Y	Y	Y	Y	n/a,	N	N	n/a,	N	N	Y	N
Others			Y	N	N	Y	Y	N	Y	n/a,	N	Y	Y	N
Total cost of government support measures for housing		% of national budget	1.2	1.9	2.3	2.8	n/a,	n/a,	0.1	n/a,	n/a,	7.2	1.3	n/a,
		% of GDP	0.2	0.9	0.7	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,	2.3	0.3	n/a,
Government spending for other social policies														
	Education	% of national budget	5.1	12.0	12.0	n/a,	n/a,	5.1	12.0	n/a,	5.7	11.2	n/a,	14.0
		% of GDP	1.0	5.8	3.6	n/a,	n/a,	1.7	n/a,	n/a,	2.8	3.6	n/a,	3.0
	Health care	% of national budget	1.8	10.0	6.2	n/a,	n/a,	14.5	13.4	n/a,	15.4	11.9	n/a,	8.0
		% of GDP	0.4	4.9	1.9	n/a,	n/a,	4.8	n/a,	n/a,	7.6	3.8	n/a,	2.0

(Source) OECD Market Survey on Housing Finance 2004 ; data in 2003 (CZ & LT: 2002); Y: Yes, N: No

3-3. Country Assessments

It is more difficult to accurately assess regulatory schemes and housing policies in respective countries. In particular, housing policy varies country by country. In this chapter, however, I tried to evaluate them in terms of households' access to housing finance, taking account of the domestic regulatory environment on risk management and the overall financial sector development, as well as the government support measures for households. Figure 18 indicates the aggregate result from Table 11:

Figure 18: Regulation & Housing Policy Matrix



PL	Poland
HU	Hungary
CZ	Czech Republic
SK	Slovak Republic
LT	Lithuania
LA	Latvia
EE	Estonia
SI	Slovenia
HR	Croatia
RO	Romania
UA	Ukraine
KZ	Kazakhstan

From Figure 18, the regulatory structures and the housing policies in study countries can be analysed as follows:

- In the regulatory structure, most of Group 1 (new EU members; Poland, Hungary, the Czech republic, the Slovak Republic, Latvia and Estonia) and Kazakhstan from Group 3 (CIS) make a group having a relatively well organised regulatory scheme, which is backed by well established legislation on the secondary mortgage market and regarding mortgage insurance schemes. Conversely, some of Group 1 (Lithuania and Slovenia), Group 2 (EU candidates; Croatia and Romania) and Ukraine from Group 3 make the second group, which contains countries for which there is currently no legislation on specialised mortgage lending institutions (except for Romania), securitisation schemes and mortgage insurance schemes (except for Lithuania), as well as relatively little compliance with international standards on financial regulations.

- In the area of housing policy, Group 1 (except for Latvia) and Ukraine from Group 3 can be regarded as having schemes equivalent to the housing policy in the advanced EU countries in terms of the social support measures for low-income segment and the fact that the government spending for housing policies has yet to bloat the national budget. However, some subsidy schemes will be debatable from a viewpoint of the total cost effectiveness (e.g. some programs have poorly targeted beneficiaries). Group 2 makes the second position in the matrix, which subsidy schemes have been improving in terms of the cost effectiveness. Latvia (Group 1) and Kazakhstan (Group 3) have currently no identified government subsidy schemes. Their mortgage markets are risk-based market-driven without the dependence of government supports. Although there are little visible state support measures, it will be expected that the Anglo-Saxon style risk management enhances the accessibility to housing finance for the low-income segment (via securitisation and mortgage insurance).

Table 11: Regulatory Structure and Housing Policy – Country Assessment Sheet

		PL	HU	CZ	SK	LT	LA	EE	SI	HR	RO	UA	KZ
Regulatory Structure	**Regulators and Supervisors**												
	- Regulators/supervisors in the primary (lending) market	2	2	2	2	2	2	2	2	2	2	2	2
	- Regulators/supervisorys in the secondary (funding) market	2+	2+	2	2+	2-	2	2-	2-	2-	2-	2-	2+
	Domestic Legal Framework												
	- Basic legislation on both primary & secondary market (property right / protect market participants appropriately)	2	2	2	2	2	2	2	2	2-	2	2	2
	- Legislation on specialised mortgage lending institution	2	2	2-	2-	1	1	1	1	1	2-	1	2
	- Criteria of mortgage lending value (exist and/or evaluated?)	2	2	1+	2	2-	2-	2-	2-	2-	1+	1+	2-
	- LTV limit criteria (primary market)	2	2	2	2	2	2	2	2-	2	2-	2-	2-
	- Bankruptcy remoteness (secondary market)	2	2	2	2	n/a,	2	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
	- Mortgage ranking of cover assets (secondary market)	2	2	1+	1+	n/a,	1+	n/a,	n/a,	n/a,	n/a,	n/a,	2
	- Government supported mortgage insurance scheme (legal setting)	1	2-	1	1	2	1	2	1	1	1	1	2
	- Regulations/supervision on private mortgage insurance scheme	1	1	1	1	1	1	1	1	1	1	1	2
	Compliance with EU/International Standards												
	- Fulfilment of EU directives (inc. UCITS directive)	2	2	2	2	1	2	1	1	1	1	n/a,	n/a,
	- Compliance with Basel BCP, IAIS ICP, IOSCO SCP, IMF MFP, OECD CG and IAS (from FSAP data)	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	2-
	- Compliance with international insolvency standards (from EBRD research data)	2-	1+	2-	2-	1	1+	2-	1+	2	2	1	2-
	Overall Financial Sector Reform												
	- Banking sector reform	2-	2	2	2	2-	2	2	2-	2	2-	1+	2-
	- Securities market reform	2	2	2-	2-	2-	2-	2-	2-	2-	1+	1+	1+
Average Performance (sum of scores divided by the number of items)		2-	2-	2-	2-	2-	2-	2-	2-	2-	2-	1+	2-
Housing Policy	**Support for Homeownership**												
	- Interest payment subsidies on mortgage loans	2+	2+	2+	2+	2-	1	2+	n/a,	1	1	2+	1
	- Housing purpose fulfilled (savings bonus)	2-	2-	2-	2-	n/a,	n/a,	2-	2-	2-	2-	n/a,	n/a,
	Support for Rental Housing												
	- Supportive to socially disadvantageous groups (low-income seg.)	2+	2+	2+	2+	2+	1	2	2+	2	2+	2	1
	Housing Taxation												
	- Preferential tax treatment	1+	2+	2+	1+	2+	1	2+	2	2+	1+	2	1
	Other Social Supports												
	- Supportive to socially disadvantageous groups (low-income seg.)	2+	2+	2+	2+	2+	1	2+	2+	2	2+	2	1
	Cost Effectiveness												
	- Share of housing related measures to the total govt. spending	2+	2+	2+	2+	n/a,	n/a,	2+	n/a,	n/a,	2	2+	n/a,
	- Share of housing related measures to GDP	2+	2+	2+	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,	2	2+	n/a,
	- Comparison with costs of other social policies	2+	2+	2+	n/a,	n/a,	3*	2+	n/a,	n/a,	2+	n/a,	3*
	- Government subsidy programs: well focused?	2-	2-	2-	2-	2-	n/a,	2-	2-	2-	2-	2-	n/a,
	- Municipalities' support measures without govt. subsidies (will it bloat the national budget?)	2-	2-	2-	2-	2-	n/a,	2-	2-	2-	2-	2-	n/a,
	Accessibility for Households												
	- Number of subsidy programs	2+	2+	2+	2+	2+	1	2+	2+	2	2+	2	1
	- Competition in the market (govt. programs do not impede active competition?)	2-	2-	2-	2-	2-	3	2-	2-	2-	2-	2-	3
Average Performance (sum of scores divided by the number of items)		2	2	2	2	2	2-	2	2	2-	2-	2	2-

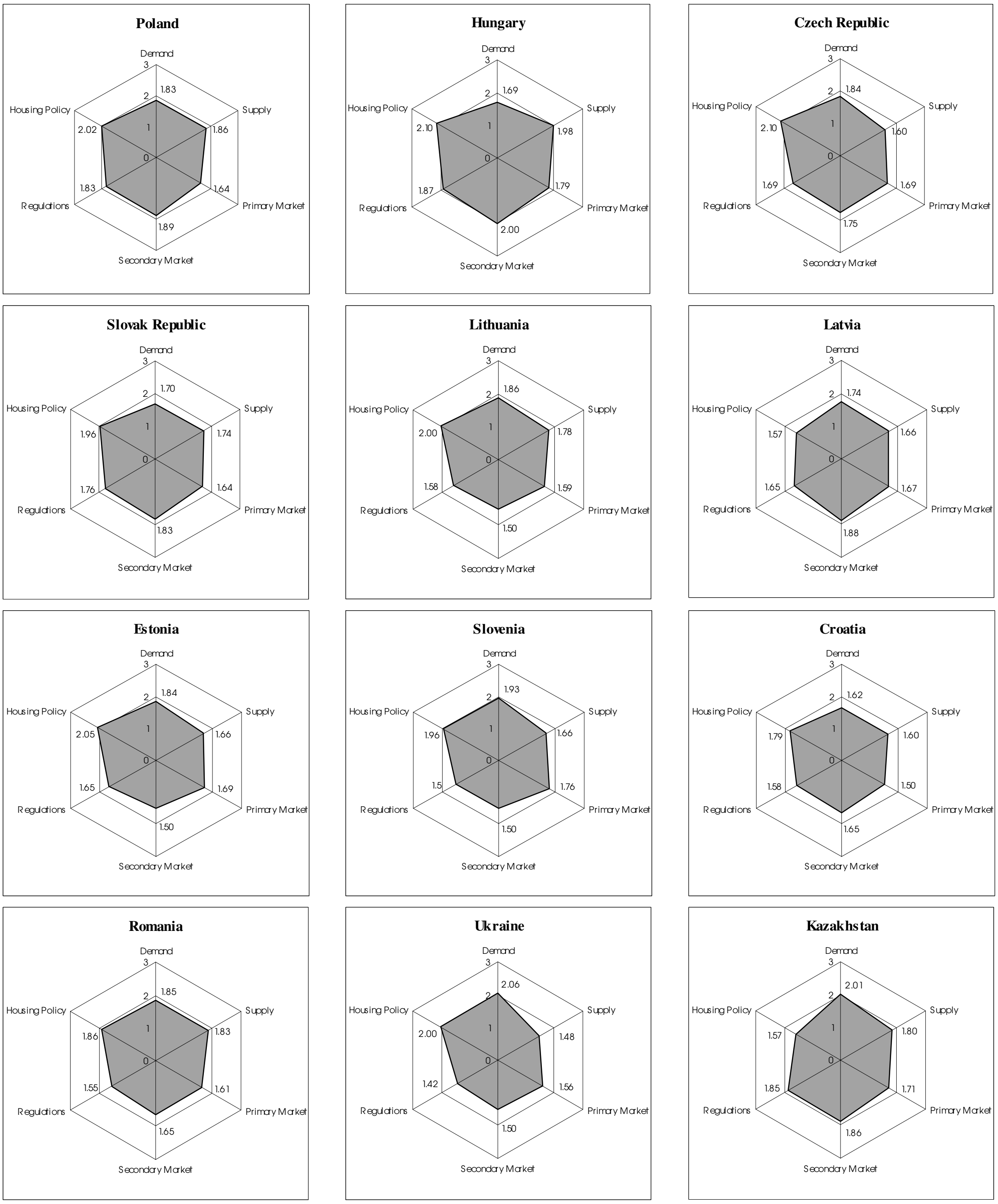
(Note) All analyses in chapter 3 have been translated into country assessment sheet in Table 11, where each condition influential in the housing finance accessibility was rated from 1 (relatively low performance) to 3 (relatively high performance) as compared to the EU level. In the definition, the rating is classified into seven categories: 1: much worse than EU; 1+: worse than EU; 2-: slightly worse; 2: EU level; 2+: slightly better than EU; 3-: better than EU; and 3: much better than EU. To calculate the average performance in each country, 0.3 point is given to "+" and deducted from original point in "-" for convenience sake. It should be noted that the performance in study countries is subjectively rated in comparison with one another, the advanced EU countries and/or the international standards. * No government subsidy schemes (no expenditures for housing policy identified)

4. Aggregate Results and Lessons

4-1. Dynamics on Housing Finance Markets

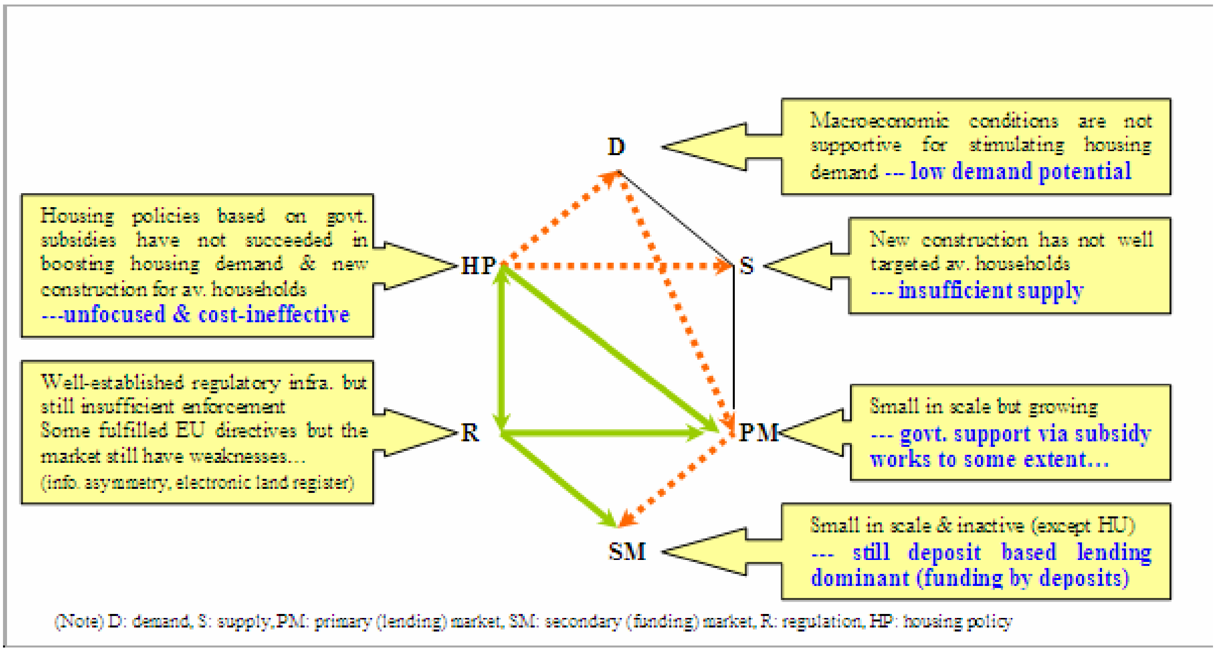
To sum up, foregoing analyses are translated into the following spider charts of housing and housing finance markets in study countries, where the score "2" in each category refers to the EU level as a benchmark.

Figure 19: Total Performance of Housing and Housing Finance Markets in Transition Economies



As indicated in Figure 19, except for housing policy, items on housing demand, housing supply, primary mortgage market, secondary mortgage market and regulations are roughly situated within the EU level in most of study countries. In those spider charts, some dynamics can be seen as follows:

Figure 20: Dynamics on Housing Finance Market in Transition Economies



- Housing policies mostly backed by government subsidies have not succeeded in boosting housing demand and new construction for average households. Most government support measures for housing are not cost efficient (e.g. unfocused subsidies such as savings bonus in some case) and are volatile in unstable macroeconomic conditions (e.g. subsidies costly in inflationary economies such as interest payment subsidies).

- Relatively low demand and insufficient supply of housing exist in study countries. Macroeconomic conditions are not supportive for the creation of housing demand while private developers have not targeted average households.

- This condition of housing market directly links to the housing finance market, which results in a small-scale lending market. However, the mortgage lending market has been rapidly growing particularly in Hungary, which is backed by the active secondary market funding (mortgage covered bonds) and government support via subsidy to some extent.

- Secondary market funding is also inactive in most study countries, where deposit based lending remains dominant, though their mortgage markets are growing. It seems that some types of government subsidies impede the development of primary and secondary mortgage markets in these countries (the obstacle of competition).

- The regulatory framework is relatively well established but not fully covering the weaknesses in housing finance markets; i.e. enforcement of market regulations is still insufficient as compared to the progress of overall financial sector reform. Although some of study countries have fulfilled the minimum standard of the EU (EU directives), their markets still have weaknesses (e.g. time-consuming land register system; i.e. insufficient electronic land register system). Also, some countries lack the core principle of mortgage lending and mortgage bonds regulations.

In this case, it may be difficult to expect the sustainable development of housing finance markets, though this cannot be applied to all study countries.

4-2. SWOT Analysis

To find out the problems to be solved, results of chapters 1 to 3 can be classified into the following strength, weakness, opportunity and threat (SWOT) matrix:

Table 12: Strengths, Weaknesses, Opportunities and Threats surrounding Housing Finance Markets in Transition Economies

Strengths	Weaknesses
- Mortgage products favourable for households (EU level) - Several government support measures for housing (interest payment subsidy/ savings bonus/ preferential tax treatment) - Moderate regulatory and supervisory structure	- Insufficient housing supply for average households - Deep-rooted deposit based lending (especially PL) - Predominant subsidy-based mortgage lending - Not yet popular mortgage securitisation - Insufficient risk management - Untransparency (little available market information)
Opportunities	**Threats**
- Relatively large-scale working age population - Positive GDP growth - Growing mortgage lending - Mortgage securitisation scheme (mortgage covered bonds) - Foreign investors & institutional investors (secondary mortgage market)	- Low housing demand potential (decreasing population/ low-income/ high price & low quality of housing) - Oligopolistic housing finance market (inactive competition) - Still insufficient enforcement of market regulations - Unfocused and cost-ineffective government subsidy schemes (low-income households untargeted) - Lack of financial education

Relatively well organised market infrastructure with proactive regulations will be a strength in the housing finance market in the region. However, inactive residential construction, deep-rooted deposit based lending backed by government subsidy, little used securitisation schemes for funding and a lack of transparency are all crucial obstacles for the sustainable development of housing finance markets.

Against this backdrop, a relatively sizable working age population, positive GDP growth, growing mortgage lending, already existing mortgage covered bond schemes and the interest of foreign investors and institutional investors in the secondary market will provide opportunities to vitalise housing finance markets in the region. Having said that, low housing demand potential, oligopolistic markets by commercial banks, insufficient enforcement of market regulations, unfocused and cost ineffective subsidy schemes, and lack of financial education for market participants will make the market development dull.

So what should be done for the sustainable development of housing finance markets? To develop the market by making the best use of opportunities and strengths, low-and middle-income households should be targeted in the lending market and by housing policy. To avoid threats to fiscal sustainability, government subsidy programs should be reviewed in terms of cost-effectiveness. To protect opportunities from weaknesses, securitisation schemes should be used more. To avoid making the market worse by threats and weaknesses, techniques of controlling risks (credit risk, market risk, prepayment risk, exchange rate risk, etc.) should be established as soon as possible.

From Table 12, eleven general problems that may impede the development of housing finance market in the region can be raised as follows:

1) Low housing demand potential
2) Insufficient housing supply for average households
3) Deep-rooted deposit based lending
4) Predominant subsidy-based mortgage lending
5) Limited mortgage securitisation
6) Oligopolistic housing finance market (inactive competition)
7) Insufficient risk management
8) Insufficient enforcement of market regulations
9) Lack of transparency (little available market information)
10) Unfocused and costly government subsidy schemes
11) Lack of financial education

1) Low housing demand potential

Housing market growth directly links to housing finance market growth. Current macroeconomic conditions in some study countries are not supportive to create housing demand and to vitalise housing finance market (i.e. low-income, high house prices and high interest rate naturally limit households' market access). A stagnant population will directly influence demand for both housing and housing finance markets negatively. Therefore, new demand of housing finance needs to be cultivated from the current working age population.

2) Insufficient housing supply for average households

New construction launched by private developers tends to target higher income people by means of providing luxury (spacious) flats or houses, because housing construction targeting low-and middle income households is riskier taking account of their higher probability of default. Such a small market segment (wealthier households) rarely contributes to vitalising the housing market.

3) Deep-rooted deposit based lending

Traditional deposit-based lending is still dominant in most of study countries, which was popularised by the German building societies. This lending method relies heavily on short- and middle-term deposits (inc. contract savings schemes) for funding. In this scheme, the credit risk is covered only by the accumulated deposits, not flexibly controlled. Furthermore, it takes a long time for borrowers to take loans. Also, this scheme mostly enjoys government subsidies (savings bonuses), which is often used not for housing purposes. Thus, deposit based lending is ineffective in terms of both the asset risk management and the cost performance, and is less customer-friendly.

4) Predominant subsidy-based mortgage lending

The mortgage market in the region is a relatively subsidised market. Most of the study countries have interest payment subsidy schemes for long-term mortgage loans, where the gap between the contractual fixed rate and the market rate is covered by subsidies until the close of the contract. In inflationary economies, this scheme is costly and will impede active competition in the market.

5) Limited mortgage securitisation

Currently, roughly half of the study countries have their own covered bond markets but, with the exception of some countries, do not make the best of a mortgage securitisation scheme. In this context, there is the fact that the mortgage loan volume itself is quite small in scale in the region. Besides, it seems that lenders (issuers) tend to hesitate to use this relatively new instrument because of the complicated process of pooling loans as cover assets. Although there is another securitisation scheme such as MBS, it is not popular in Europe. At present, there is no MBS market in study countries. Important factors include 1) the application of a new system is always costly; 2) there is little experience for market participants as well as policy makers (little accumulated data); and 3) pricing techniques as well as the common valuation rule have yet to be established. Thus, only one securitisation scheme, mortgage covered bonds, is available in study countries.

6) Oligopolistic housing finance market (inactive competition)

The mortgage market in the region is an oligopolistic market dominated by a few large-scale lenders that successfully obtained the right to receive government subsidies. In practice, their privileges to enjoy subsidies have made a barrier to new entrants. (Latvia and Kazakhstan have no government subsidy schemes identified).

7) Insufficient risk management

In most of the study countries, there are low market risks due to government subsidy programs (interest payment subsidy). However, this is not a sound lending structure as mentioned above. Market risks are obviously involved in mortgage lending. Besides, there are several types of specific risks; e.g. credit risks, liquidity risks, prepayment risks, foreign exchange rate risks, etc. The subsidy based lending will hinder the development of risk management techniques in the region, as well does the deposit based lending.

8) Insufficient enforcement of market regulations

Some of study countries have regulations on mortgage lending and mortgage bonds consistent with EU directives (i.e. basic legal infrastructure has been established in the region). However, the enforcement of laws and regulations still seems to be insufficient. Also, compliance with international financial standards has yet to be sufficient.

9) Lack of transparency (little available market information)

Mortgage markets in the region are still not so transparent. There is little mortgage lending information available publicly. There is no information sharing system of mortgage lending including price information and debtors' list. Also in the covered bond market, it is very difficult to get just-in-time accurate market information because issued bonds are little listed in the stock exchange. Most of the transactions are conducted by private placements.

10) Unfocused and costly government subsidy schemes

As mentioned, wide-ranging government support programs are not well targeted. Stiff subsidy programs are often cost-inefficient and ineffective.

11) Lack of financial education

The securitisation scheme such as covered bonds is a relatively new concept in study countries. Due to the complicated instrument, lenders (issuers) tend to hesitate to use this scheme as mentioned above. Also, specific training will be necessary to understand sophisticated mortgage products such as the dual-indexed mortgage (DIM) in Poland and the differed payment mortgage (DPM) in Hungary.

Possible Solutions

For the above mentioned problems, possible solutions might be as shown in Table 13:

Table 13: Possible Solutions

Problems	Possible Solutions
1) Low housing demand potential	1) Cultivate new market segments: little targeted low- and middle-income households
2) Insufficient housing supply for average households	2) Encourage residential construction for low- and middle-income households
3) Deep-rooted deposit based lending	3) Shift to mortgage-based lending with the securitisation scheme
4) Predominant subsidy-based mortgage lending	4) Shift to market-based mortgage lending through reforming subsidy programs
5) Limited mortgage securitisation	5) Effectively use the mortgage as collateral / Consider another securitisation scheme (MBS)
6) Oligopolistic housing finance market (inactive competition)	6) Create an equal footing competitive environment in the market through reforming the subsidy privileges for specific lenders
7) Insufficient risk management	7) Create and use the standard of risk-based asset valuation (common valuation rule in transition economies) / Make the best of securitisation schemes and mortgage insurance schemes as risk control methods
8) Insufficient enforcement of market regulations	8) Fully implement laws and regulations consistent with EU directives and international standards
9) Lack of transparency (little available market information)	9) Establish the information sharing system of mortgage for market participants / encourage public issuance of mortgage covered bonds
10) Unfocused and costly government subsidy schemes	10) Do major reforms of government subsidy programs
11) Lack of financial education	11) Provide training programs and seminars for market participants to activate the housing finance market in transition economies

1) Cultivate new market segments: little targeted low- and middle-income households

In housing and housing finance markets in the region, low- and middle-income households have been little targeted. Although the government has provided support measures for low-income segments by means of the construction of rental housing, this is not a market-based scheme (subsidy programs). If their risks are properly controlled, low- and middle-income households will have a good potential to provide new demand for housing.

2) Encourage residential construction for low- and middle-income households

Promoting new residential construction for low- and middle-income households is indispensable to attract this new demand group to the housing finance market. Also in this case, the risk control to avoid their defaults is a critical issue to be managed.

3) Shift to mortgage-based lending with the securitisation scheme

Taking account of the asset risk management, the mortgage lending system in some countries should shift to mortgage-based lending accompanied by a securitisation scheme. In this regard, Hungary has been successfully moving to a mortgage lending system with mortgage covered bonds, where mortgages are used as cover assets of mortgage bonds (lien) and the risks are transferred to bond investors.

4) Shift to market-based mortgage lending through reforming subsidy programs

The subsidy-based lending scheme is not market-based, which impedes the sound market; i.e. creates a barrier to new entrants by providing a few large-scale lenders with privileges (subsidies). This is also fragile and costly system in inflationary economies (cost inefficient). It is crucially important to shift from "protected" subsidy-based lending to "open" market-based mortgage lending in order to make the market more active and global. Government subsidies should play a supplementary role to vitalise the market.

5) Effectively use the mortgage as collateral / consider another securitisation scheme (MBS)

Because of little experience regarding secondary market instruments, market participants tend to hesitate to use securitisation schemes in most of the countries. Mortgage lenders (mortgage bond issuers) should positively adopt this new scheme, in addition to or in place of the traditional deposit-based lending. In this context, financial education for market participants will be important. To diversify the way to control risks, they should consider the possibility of MBS, learning from UK and French MBS schemes. Poland is one step ahead in this regard (MBS legal framework). However, it should be avoided just to imitate securitisation schemes of other countries. Country specific issues should be scrutinised before developing own securitisation scheme.

6) Create an equal footing competitive environment in the market through reforming the subsidy privileges for specific lenders

To create a sound competitive environment, the subsidy privilege that a few lenders hold should be appropriately reformed in order to facilitate new lenders to enter into the market in the region. The government should take a substantial step to open up to the global lending infrastructure, taking account of the Euro zone market. They have yet to introduced the Euro but are aiming at being a member of EMU (this is not the case for Group 3 (CIS)).

7) Create and use the standard of risk-based asset valuation (common valuation rule in transition economies) / Make the best of securitisation schemes and mortgage insurance schemes as risk control methods

In market-based lending, it is indispensable to create the standard of risk-based asset valuation. Although study countries, with some exceptions, have their own lending valuation rules, there is currently no common valuation rule in the region. Taking account of the trend towards a single mortgage market in the EU, a single valuation rule is indispensable particularly in Group 1(new EU members) and 2 (EU candidates). Also, off-balance securitisation (MBS) might be considered as one of the risk management techniques, where the credit risk and the market risk are transferred to investors. In addition, mortgage default insurance schemes provided by the government and/or private insurance companies will be a promising way to control credit risks (explained in the following chapter).

8) Fully implement laws and regulations consistent with EU directives and international standards

In particular, Group 1 and 2 do their best to fully implement their laws and regulations consistent with EU directives as soon as possible, considering the single mortgage market in the EU (harmonisation).

In parallel, all study countries should do their best to enhance the compliance level with international financial standards, considering cross-border activities.

9) Establish the information sharing system of mortgage for market participants / Encourage public issuance of mortgage covered bonds

For the primary mortgage market, the establishment of information sharing systems (e.g. price sharing, disclosed debtors' list, etc.) will be important to activate the mortgage lending market in the region. Also, for the secondary mortgage market, public issuance should be encouraged to enhance liquidity.

10) Do major reforms of government subsidy programs

In the process of the transition to market-based lending, unfocused and cost-ineffective government subsidy programs are obstacles for the sound development of housing finance markets in the region. To vitalise the market, the reform of subsidy programs should be conducted, taking account of the country specific environment.

11) Provide training programs and seminars for market participants to activate the housing finance market in transition economies

To activate the mortgage markets in the region, financial education for market participants (lenders, borrowers and investors) will be a critical issue. The government and international organisations can contribute through providing training programs and seminars in this regard.

4-3. Lessons

Taking account of the foregoing results, a key for the sustainable development of housing finance market in transition economies is, firstly, to establish a sophisticated risk management system in the market; i.e. a market-based mortgage lending system with secondary market funding (covered bonds/ MBS), targeting low- and middle-income households who have been little targeted so far. Low-and middle-income households involve much higher credit risks than wealthier people. As a sophisticated risk control instrument, securitisation schemes should be more actively used in the market, which will attract institutional investors to the secondary mortgage market. Also, mortgage products for low-and middle-income households such as DIM should be developed but must be plain instruments for borrowers; note the situation in Poland where the demand for DIM has been decreasing because of its complicated nature. Secondly, a housing policy efficient and effective to support low-and middle-income households is indispensable for the sustainable development of the market. To this end, already old-fashioned deposit based lending should be removed step by step from the housing finance system in the region, with the reform of government subsidy programs. Core issues for the development of a well-functioning housing finance system in transition economies are summarised as follows:

For a well-functioning market-based (customer-based) mortgage lending system

- Establish sophisticated risk management techniques of mortgage lending for low- and middle-income households.

- Develop mortgage products to stimulate mortgage issuance. Consider critical requirements of mortgage design for low- and middle-income households (e.g. plain and cost-efficient instruments for borrowers, low-risk instruments for lenders, and effective mortgage insurance scheme).

- Make the best of secondary market funding arrangements (mortgage covered bonds/ MBS) as effective risk controllers.

- Attract institutional investors such as pension funds and insurance companies to the secondary mortgage market, which will particularly contribute to growing mortgage markets, improving liquidity and developing the mortgage market infrastructure.

For a well-organised regulatory structure and well-focused government support measures (housing policy)

- Establish regulatory and supervisory structures fully consistent with EU rules and/or international standards in order to establish the safety and soundness of mortgage lending and funding markets in the region. Basic rules have been already introduced in study countries but more must be done to keep up with the EU legal conditions for a single European mortgage market and/or the international rules on financial markets.

- Establish effective regulations regarding non-depository specialised mortgage-lending institutions. The creation of the legal framework for specialised mortgage banks might be an effective means of vitalising the mortgage market in some countries where the mortgage market is just one part of the total banking sector.

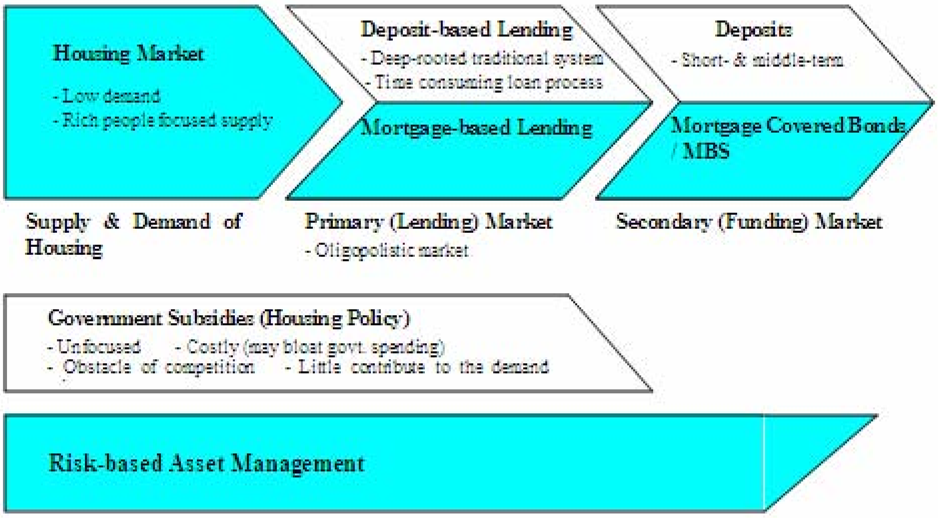
- Establish regulatory and supervisory frameworks suitable to the development of both primary and secondary mortgage markets (e.g. legal framework of alternative funding instruments such as MBS).

- Secure the enforcement of regulations in respective primary and secondary mortgage markets in accordance with EU rules and/or international standards.

In addition, it will be expected that a single mortgage market will bring several synergy effects to most of the study countries (e.g. encouragement of economic growth/ improvement of housing condition). Although some of the countries have achieved EU membership, they have yet to obtain membership in the European Economic and Monetary Union (EMU). It will take a bit of time for those countries to introduce the Euro. In this context, governments in the region might establish short- and long-term action plans taking account of active Euro-based mortgage transactions in the future.

In parallel with that, there is a clear business chance in mortgage markets in transition economies; i.e. the mortgage default insurance business (explained in the following chapter). The mortgage default insurance scheme can be a promising risk management technique in the region, which would enable low- and middle-income households to take high LTV loans and enhance the liquidity of the secondary mortgage market (i.e. as insured mortgages are higher ranking mortgages, cover assets based on insured mortgages enhance investors' confidence in covered bonds). Also, mortgage information collected in the process of the loan assessment can be provided to market participants (information sharing system). For the successful introduction of the mortgage insurance scheme, firstly a government mortgage insurance system and then a private mortgage insurance system will be desirable. In addition to that, the reform of government subsidy programs and the establishment of appropriate legal infrastructure of the secondary mortgage market are prerequisite.

To sum up, as shown in Figure 21, it will be critical to well manage the painted market process for the development of market-based housing finance systems in transition economies.



5. Mortgage Insurance

This final chapter touches upon mortgage default insurance. Mortgage insurance will be a key product as an innovative instrument to reallocate risks, which would be expected to expand the mortgage finance market and further the development of securitisation. The purpose of this chapter is to discuss the benefits of a mortgage insurance system for borrowers, lenders, investors and government, to review the recent progress of mortgage insurance markets in study countries, and to discuss the potential for private mortgage insurance business in the region.

5-1. System and Benefits

The mortgage insurance system is a critical risk control scheme particularly for high LTV lending, which protects lenders and investors from borrowers' default on residential mortgages. The basic mortgage insurance scheme is indicated in Figure 23. Basically, borrowers pay insurance premiums to lenders, besides loan repayments, in order to enjoy the benefits of mortgage default insurance. Then, the premiums are transferred to mortgage insurers via lenders. Mortgage insurance is either obligatory or voluntary for borrowers to take loans, which depends on each country's condition (e.g. Estonia: voluntary scheme). Although mortgage insurance fully protects lenders, the actual amount that mortgage insurers would pay in response to the lender's payment claim will depend on the mortgage (property) value in the general scheme. A typical mortgage insurance product is as shown in Figure 22, where the maximum amount of the mortgage insurer's cover is limited to USD 10,000, for example. According to this scheme, the bank may lose or gain depending on the (sold) mortgage value.

Figure 22: Typical Mortgage Insurance Product (virtual model)

Mortgage loan $ 100 k	**MI covers $ 10 k** **Mortgage value $ 80 k**	**MI covers $ 10 k** **Mortgage value $ 90 k**	**MI covers $ 5 k** **Mortgage value $ 95 k**	**Mortgage value $ 110 k**
Bank	$ 10 k loss	Breakeven	Breakeven	$ 10 k gain
Mortgage Insurer (MI)	$ 10 k max. payment	$ 10 k max. payment	$ 5 k payment	No payment

(Note) This model was made out from the explanation of GE Mortgage Insurance.

The mortgage insurance system brings several benefits to all market participants: borrowers, lenders, investors and the government.

Firstly, mortgage insurance enables borrowers to take housing loans large enough to purchase a home with a low down payment[5] (usually cash less than 20% of home value). This means that home buyers, particularly low- and middle-income households who may not be able to purchase their houses because of an insufficient amount of cash, are able to realise their desire for homeownership more readily by means of taking high LTV loans guaranteed by a third-party; i.e. mortgage insurance companies and/or the government. Borrowers also enjoy relatively low interest rates in spite of the higher risk of the loans because of this third-party guarantee. This instrument will enhance households' access to housing finance.

Secondly, mortgage insurance protects lenders and investors from borrowers' defaults on housing loans by means of transferring risks involving loans to a third-party. Because of this function (risk transfer), lenders can better control credit risks and thereby relieve their capital burdens. In parallel with that, lenders can expand their target customer base to include low- and middle-income households who do not have the capacity to make a sufficient down payment; i.e. high LTV lending with safeguards. This will also facilitate lenders' funding for housing loans through secondary markets such as the mortgage bond market and the MBS market because securitised housing loans with a third-party guarantee are regarded as relatively safe assets for investors.

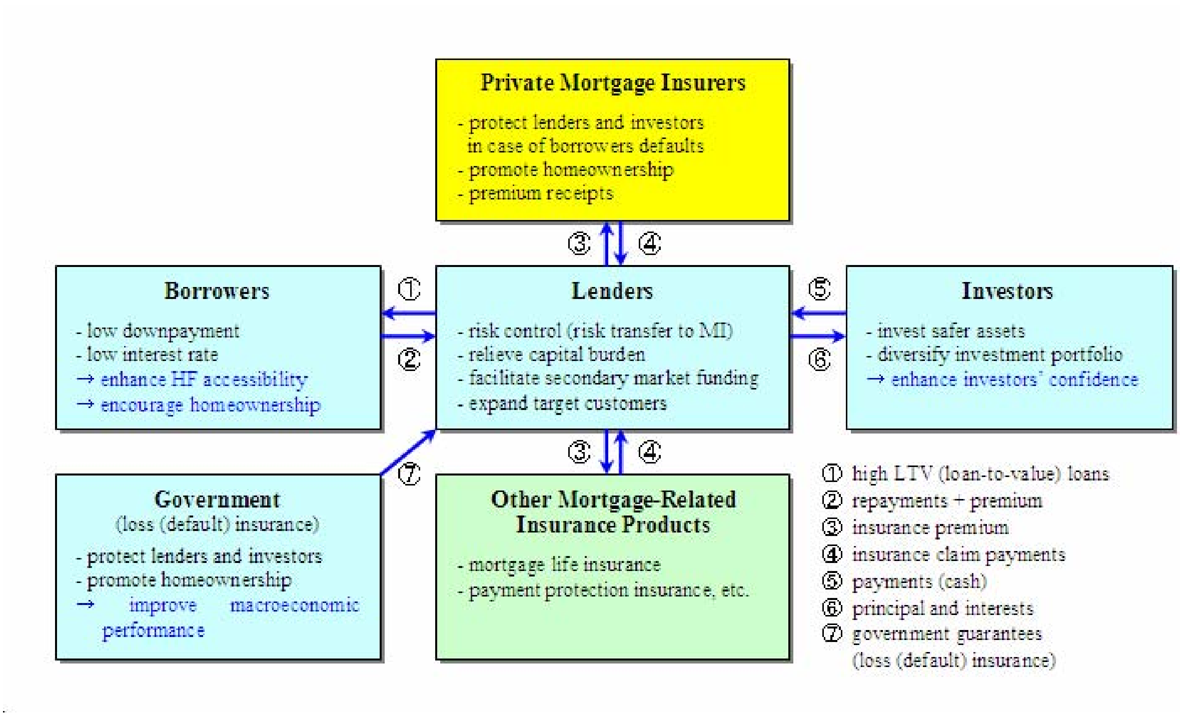
Thirdly, for investors, mortgage insurance allows them to diversify their investment portfolio because mortgage bonds and/or MBS backed by mortgage insurance are considered as relatively safe products as mentioned. This will enhance investors' confidence in the secondary mortgage market.

Lastly, for government, a public mortgage insurance scheme will help to promote homeownership further (housing privatisation and new housing purchase), which may stimulate new construction demands. It may be expected to improve macroeconomic performance in respective countries. When considering the government guarantee program, it should be well-controlled taking account of the role of private mortgage insurance schemes and needs of the public, because its capital source is usually the national budget (tax). As there is no long-term experience with mortgage insurance schemes in the region (also the mortgage market itself is newly developing in the region), it will be important that the development of a government guarantee program is first and then as experience is accumulated (e.g. risk management techniques) it can be applied to a private guarantee system, as the United States has done (long-term assessment of the scheme).

Besides mortgage insurance, there are some complementary products; which are completely distinguished from the mortgage default insurance: e.g. 1) mortgage life insurance: life insurance that covers the remaining loan amount in case of the borrower's death; and 2) payment protection insurance: credit insurance that supports the borrower's income in case of its unexpected unemployment or disability.

It will be easily considered that high LTV lending for low-and middle-income households involves high default probabilities. In the United States, generally LTV loans over 80% (i.e. down payment less than 20% for borrowers) are regarded as high LTV lending, though it depends on respective products.

Figure 23: Mortgage Insurance System and Benefits



5-2. Mortgage Insurance Markets in Transition Economies

The mortgage default insurance market has not been developed in transition economies. At present, laws and regulations on mortgage default insurance have been little developed in the region. Relatively low quality of housing (i.e. relatively low value as lien) and poor risk management techniques mostly caused by government subsidy programs have impeded the development of a mortgage insurance system in those countries, much more so the high default risks.

As shown in Table 14, Hungary, Lithuania, Estonia and Kazakhstan have public mortgage insurance schemes, which contribute to their high LTV lending. Also, domestic private mortgage insurance companies are operating in Poland and Kazakhstan. However, because of the lack of regulations on mortgage insurance, the activities are not legally protected in Poland. As a matter of fact, there is no long-term experience on mortgage default insurance in the region.

Table 14: Mortgage Insurance Structure

	Private Mortgage Insurance	Government Guarantees	Complements
Poland	- TU EUROPA SA - CIGNA STU	n/a,	- Mortgage life insurance - Payment protection insurance, etc
Hungary	n/a,	State guarantee (default insurance)	n/a,
Czech Rep.	n/a,	n/a,	n/a,
Slovak Rep.	n/a,	n/a,	n/a,
Lithuania	n/a,	JSC Housing Loan Insurance	n/a,
Latvia	n/a,	n/a,	- Real estate insurance
Estonia	n/a,	The Estonian Credit and Export Guarantee Fund, KredEx	n/a,
Slovenia	n/a,	n/a,	n/a,
Croatia	n/a,	n/a,	n/a,
Romania	n/a,	n/a,	n/a,
Ukraine	n/a,	n/a,	- Mortgage life insurance - Insurance to borrowers' work capacity - Real estate insurance - Title insurance
Kazakhstan	"Kazakhinstrakh JSC", etc. (17 companies)	Mortgage Guarantee Fund of Kazakhstan JSC	n/a,

(Source) OECD Market Survey on Housing Finance 2004

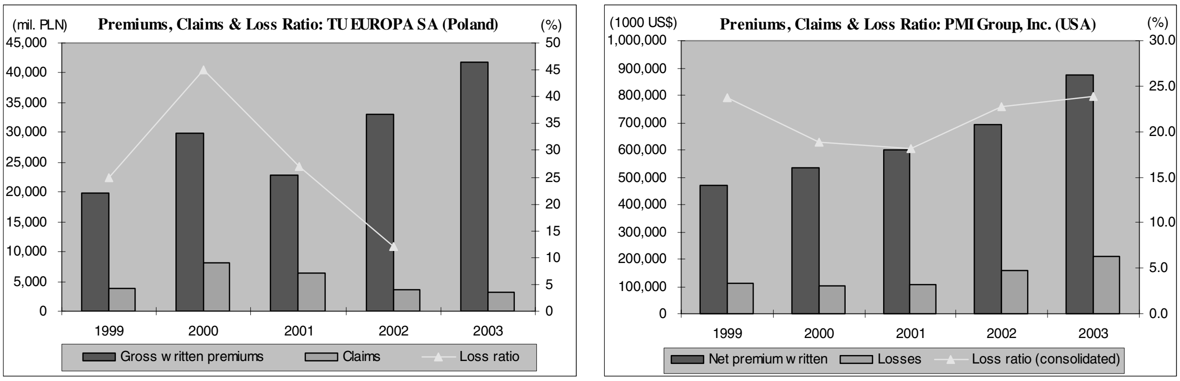
Recently, U.S.-based multinational firms and insurance companies such as GE and PMI Group have targeted the European mortgage insurance market. Since 2004, GE has transferred its mortgage insurance business into a newly established insurance company called the Genworth Financial (Genworth) through an initial public offering (IPO)[6]. Genworth covers the European market as one of its strategic marketing areas[7]. The PMI Group is a leading provider of private mortgage insurance in the U.S., which opened a sales and marketing office in Ireland in early 2000 to cover the EU mortgage markets. Currently, they have not yet entered the Central and Eastern European markets but have clearly targeted this region as part of the EU countries.

As an example of the mortgage insurance business in study countries, TU EUROPA SA has been moderately operating in spite of no legal foundation. TU EUROPA SA started its insurance operations in 1995 and was listed on the Warsaw Stock Exchange in 1999. Since 2001, its operations have been divided into non-life (mortgage, car and property insurance) and life insurance business managed by different affiliated companies (TU EUROPA SA: non-life insurance; TU na Zycie EUROPA SA: life insurance). Mortgage default insurance is a principal product of TU EUROPA SA, which consists mainly of three products: 1) mortgage insurance for banks within the bridge period (covering bank's loss against borrowers' default within the period from the loan release to the mortgage registration); 2) mortgage insurance against legal faults (protecting the bank against borrowers' inability to repay in case that the bank is unable to secure the loan through mortgage registration); and 3) high LTV mortgage insurance (securing the repayment of mortgage loan by the borrower who does not have an adequate deposit). As complements, TU na Zycie EUROPA SA provides mortgage life insurance and payment protection insurance. Types of products are equivalent to those in the U.S.

In order to assess the performance of TU EUROPA SA, I tried to compare its profitability with PMI as a potential competitor in the Central and Eastern European market. Figure 24 shows revenues arising from insurance premiums, claim expenses and loss ratios in both TU EUROPA SA and PMI, which are calculated based on their published balance sheets (BS) and profit and loss statements (P/L). It should be noted that life insurance accounts are excluded from the BS and P/L of TU EUROPA SA but car insurance accounts remain, and that the BS and P/L of PMI Group are consolidated statements. According to Figure 24, insurance premiums have been growing in TU EUROPE SA, where the claim expense accounted for 8% of premium revenues in 2003. The loss ratio was 12% in 2002 (data in

2003 is not available), which is well below that in PMI (24% in 2003). However, both loss ratios are very high. It seems not to be a genuine loss ratio of mortgage insurance in each company.

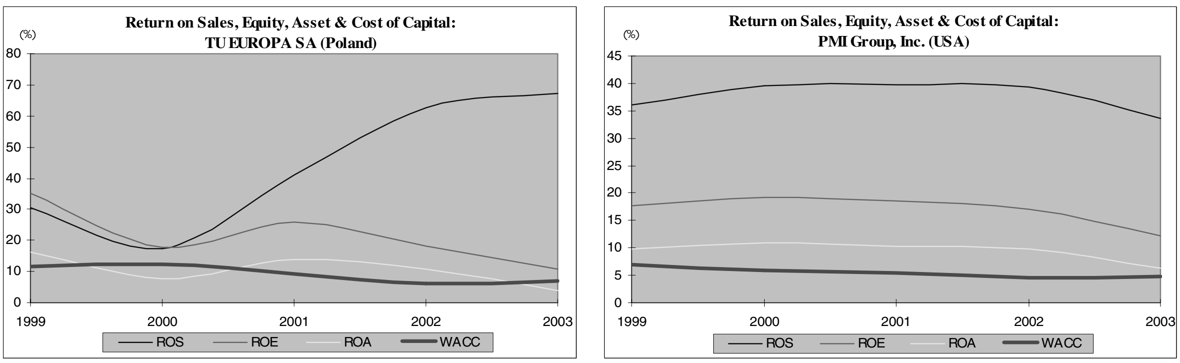
Figure 24: Premiums, Claims and loss Ratio in Selected Mortgage Insurers



(Source) TU EUROPA SA Annual Reports 2000-2003 *(Source) The PMI Group Annual Report 2003*

Next, as indicated in Figure 25, the capital cost of TU EUROPA SA was under ROS, ROE and ROA in 1999, 2001 and 2002 but it exceeded ROA in 2000 and 2003 (i.e. costly operating). In comparison, the capital cost of PMI has been kept under ROA (at least until 2003). This means that the profitability of TU EUROPA SA is still volatile as compared to its potential competitor. However, taking account of the small scale of the mortgage market in Poland, it can be said that the overall performance of TU EUROPA SA has been going well at present. In this background, there is the fact that TU EUROPA SA mainly makes deals with large- and middle-scale partner banks (21 domestic and foreign banks in 2003, where it can be considered that the mortgage value has been carefully assessed according to the valuation rule), which may be expected to reduce the loss ratio of TU EUROPA SA.

Figure 25: Return on Sales, Equity, Asset and Capital Cost in Selected Mortgage Insurers



(Source) TU EUROPA SA Annual Reports 2000-2003 *(Source) The PMI Group Annual Report 2003*

(Note) The cost of capital was calculated to compare with return on sales (ROS), return on equity (ROE) and return on asset (ROA). Because of its capital structure of only equity funding (no long-term debt) the rate on capital asset pricing model (CAPM) was regarded as the weighted average cost of capital (WACC) in TU EUROPA SA. Its company beta (β) was picked up from the Thomson Financial Datastream (little volatility: 0.07-0.54 during 1999-2003). The yield of 10-year government bond was used as the risk-free rate. The market risk premium of 5% was used in the calculation of WACC (empirical data).

Thus, the mortgage insurance business can be a promising niche business in transition economies when taking two facts into consideration: 1) mortgage lending has been growing in the region and 2) there are large numbers of potential borrowers who have been little targeted so far; i.e. low- and middle-income households. As mentioned, mortgage insurance allows households who do not have enough money for the house purchase to take loans with low down payments; i.e. high LTV lending for low- and middle-income households. By means of mortgage insurance schemes, lenders are able to widen their market segments to the low- and middle-income segments and borrowers are able to purchase homes (or renovate, enlarge or alter their houses) with low down payments. In addition, insured mortgages are regarded as high ranking mortgages, which are more preferable than normal mortgages, as cover assets of mortgage bonds. This enhances investors' confidence to the mortgage covered bond market in the region.

However, the following issues should be considered in attempting to create a well functioning mortgage insurance market in transition economies:

- Public mortgage default insurance schemes
- Legal framework on mortgage default insurance (establishment of necessary laws and regulations)
- Company rating

Firstly, at present, there is no government supported mortgage default insurance scheme in most of the study countries. Even in countries already having a public scheme, there is little accumulated data and experience available through the public system. It will be indispensable that the public mortgage default insurance system is first established through a subsidised program in order to collect sufficient data and operating techniques and then the private schemes can be established based on such government experiences. This will need a relatively long-term action plan to introduce the public system. The mortgage insurance market should be developed step by step in the region because high LTV lending operations require sophisticated risk management techniques. In this context, the Polish case (two private mortgage insurers) seems to be challenging because there is no public scheme (no available data from the government) as well as no legal framework on mortgage default insurance.

Secondly, it will be also indispensable to establish necessary laws and regulations on mortgage default insurance schemes if low- and middle-income households are targeted in the housing finance market in the region. As for the cash flow insurance schemes, some of study countries have similar schemes in their subsidy programs. However, government support measures for lenders in case of borrowers' default have yet to be well developed because the traditional deposit-based lending does not suppose such a case. In parallel with the creation of the public scheme, its legal setting should be developed at the same time.

Finally, the company rating is important for mortgage insurers to smoothly operate their business. PMI has obtained AA (very strong) from Standard & Poor's (S&P) and Fitch Ratings (Fitch) and Aa3 (excellent) from Moody's investors service (Moody's). Genworth has also obtained a rating of AA from S&P and Fitch and Aa2 (excellent) from Moody's. However, company ratings are not identified in mortgage insurers in study countries at this moment. In Poland, as its operations are mainly conducted with partner banks, the company rating may not be influential for its business immediately, but it will be necessary if the mortgage insurance market grows because active competition may occur.

To sum up, the mortgage insurance business has high growth potential as a niche market in transition economies. To this end, a well established combination of private mortgage insurance schemes with government schemes will be more important to vitalise housing finance markets in the region. However, it will take a long time to make the mortgage insurance market function because of so far little experience of its system.

Conclusion

The best practice towards a well functioning housing finance market in transition economies will be to establish a risk-based mortgage lending system supported by a securitisation scheme, targeted to low- and middle-income households, with the removal of cost-ineffective subsidy schemes and deposit based lending. In this context, the best use of mortgage insurance schemes will be a key to vitalise the market. Also, the business chance will be in the mortgage insurance business with an IT system. IT as a competitive weapon will play a supportive role in activating the market (information sharing system).

For the active market and the success of business, however, culture gap must be well managed particularly in case of the cross border transaction. In addition, financial education on sophisticated risk control techniques will be necessary for market participants, because lenders, borrowers and investors seem not to be so familiar with the sophisticated mortgage lending schemes in the region. Special training will be necessary for them, which responsibility is resting mainly with the government and international organisations.

It should be noted that this study is not always applied to all of the transition economies because each has developed its own housing finance system reflecting its historical and cultural background. However, this paper will provide an overall view of the mortgage markets in the region. Considering all the factors mentioned through this paper, it is expected that transition economies smoothly move to the risk-based mortgage lending system in the true meaning and that the government actively plays a supporting role in the development of its housing finance market with flexibility.

NOTES

1 IPO was conducted on 15 November 2004 in the Warsaw Stock Exchange. 38.5% of the shares were traded.

2 Romania started its CSS in May 2003.

3 In the fourth quarter of 2004, Slaski issued one more mortgage bond (30 million PLN).

4 Data from "Mortgage Banks and the Mortgage Bond in Europe, 4th Edition" European Mortgage Federation

5 Down payment is the amount one pays for property in addition to the debt incurred (*Dictionary of Real Estate Terms, 6th edition*).

6 GE has sold 30% of Genworth's equity in the IPO since January 2004. GE's ownership of the Genworth has been reduced (over the next 3 years) and the Gneworth is moving onto a fully independent company.

7 Mortgage insurance business in the Genworth covers the U.S., Canada, Europe, Australia and Newzealand. In Europe, it covers 9 countries (Germany, Austria, Switzerland, UK, Ireland, Italy, Netherlands, Portugal and Spain) at present.

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ANNEX 1: GENERAL INDICATORS

1. Population and Labour Force

	1999	2000	2001	2002	2003	2004
Population (million people)						*
Poland	38.3	38.3	38.3	38.2	38.2	38.2
Hungary	10.2	10.2	10.2	10.1	10.1	10.0
Czech Republic	10.3	10.3	10.2	10.2	10.2	10.2
Slovak Republic	5.4	5.4	5.4	5.4	5.4	5.4
Lithuania	3.5	3.5	3.5	3.5	3.5	3.5
Latvia	2.4	2.4	2.4	2.4	2.3	2.3
Estonia	1.4	1.4	1.4	1.4	1.4	1.3
Slovenia	2.0	2.0	2.0	2.0	2.0	2.0
Croatia	4.6	4.4	4.4	4.4	4.4	4.4
Romania	22.5	22.4	22.4	21.8	21.7	21.7
Ukraine	49.5	49.0	48.2	47.8	47.5	47.2
Kazakhstan	14.9	14.9	14.9	14.9	15.0	15.0
EU25	450.2	450.8	452.3	453.4	454.6	455.7
(% change)						
Poland	0.0	0.0	na	-0.1	-0.1	0.0
Hungary	-0.3	-0.2	-0.2	-0.4	-0.2	-1.2
Czech Republic	0.0	-0.7	-0.3	-0.4	0.1	0.0
Slovak Republic	0.7	0.4	-0.2	-0.1	0.0	0.0
Lithuania	na	-0.8	-0.6	-0.3	-0.6	-0.3
Latvia	-0.9	-0.9	-0.6	-0.8	-0.6	-0.5
Estonia	-0.7	-0.4	-0.4	-0.4	-0.7	-3.7
Slovenia	0.2	0.2	0.1	0.2	0.2	0.0
Croatia	-1.5	-1.5	-1.9	-2.4	-2.9	-0.9
Romania	-0.2	-0.1	-0.2	-2.8	-0.3	-0.1
Ukraine	-0.8	-0.8	-0.8	-0.8	-0.6	-0.6
Kazakhstan	na	-0.2	-0.1	0.1	0.6	0.3
EU25	0.2	0.3	0.3	0.3	0.2	0.2

(Source) Economist Intelligence Unit (EIU) Country Reports and Profiles; end-year data
* estimate

	1999	2000	2001	2002	2003
Labour Force (million people)					
Poland	17.2	17.3	17.2	17.1	17.0
Hungary	3.8	3.9	3.9	3.9	3.9
Czech Republic	4.9	4.9	4.9	4.9	4.9
Slovak Republic [a]	2.0	2.0	2.0	2.0	2.6
Lithuania	1.9	1.7	1.6	1.6	1.6
Latvia	1.1	1.1	1.1	1.1	1.1
Estonia [b]	0.7	0.7	0.7	0.7	0.7
Slovenia [c]	1.0	1.0	1.0	1.0	1.0
Croatia	1.7	1.7	1.7	1.7	1.7
Romania [c]	11.6	11.6	11.5	10.1	na
Ukraine [c]	20.0	20.4	20.2	20.4	20.6
Kazakhstan	7.1	7.1	7.5	7.4	7.6
EU25	208.3	210.3	211.4	212.7	213.8
(share of population)					
Poland	44.9	45.2	45.0	44.8	44.5
Hungary	37.3	37.8	38.0	38.2	38.8
Czech Republic	47.3	48.0	48.3	48.5	48.4
Slovak Republic	36.8	36.6	37.1	37.2	47.8
Lithuania	52.6	47.6	46.9	46.8	47.5
Latvia	47.1	46.2	46.9	47.8	48.3
Estonia	48.0	48.3	48.4	48.0	49.0
Slovenia	48.3	48.6	49.1	48.7	48.1
Croatia	37.0	38.8	38.9	39.4	38.0
Romania	51.5	51.6	51.3	46.3	na
Ukraine	40.5	41.7	42.0	42.7	43.3
Kazakhstan	47.3	47.8	50.4	49.8	51.1
EU25	46.3	46.7	46.7	46.9	47.0

(Source) EIU Country Reports and Profiles; [a] 2003: CIA World Factbook; [b] calculated from unemployment rate (EIU)
[c] Country Note on OECD Housing Finance Workshop in 2004

2. Gross Domestic Product

	1999	2000	2001	2002	2003	2004		2004
GDP at current prices (USD billion)						*		*
Poland	164.5	166.6	185.6	191.4	209.5	241.7	**Germany**	2,691
Hungary	48.0	46.7	51.8	64.9	82.8	103.1	**UK**	2,110
Czech Republic	55.0	55.7	60.9	73.8	89.8	104.7	**France**	2,019
Slovak Republic	20.4	20.3	20.9	24.2	32.5	42.3		
Lithuania	10.8	11.4	12.1	14.1	18.4	21.8		
Latvia	7.2	7.7	8.2	9.2	11.1	12.6		
Estonia	5.6	5.5	6.0	7.0	9.1	11.1		
Slovenia	20.1	19.1	19.6	22.1	27.7	32.9		
Croatia	19.9	18.4	19.9	22.8	28.8	33.9		
Romania	35.6	37.1	40.2	45.8	57.0	72.4		
Ukraine	31.6	31.3	38.0	42.4	49.5	69.5		
Kazakhstan	16.6	18.3	22.2	24.6	29.7	39.9		
EU25	8,905	8,253	8,312	9,082	11,027	12,523		

(Source) EIU; * estimate

	1999	2000	2001	2002	2003	2004		2003
GDP per capita (USD)					*	*		
Poland	4,011	4,241	4,739	4,924	5,483	6,327	**Germany**	29,258
Hungary	4,757	4,637	5,083	6,581	8,233	10,310	**UK**	29,759
Czech Republic	5,332	4,984	5,547	6,742	8,759	10,265	**France**	29,294
Slovak Republic	3,651	3,554	3,696	4,403	5,989	7,833		
Lithuania	3,086	3,260	3,477	4,066	5,320	6,319		
Latvia	3,032	3,268	3,511	3,949	4,758	5,431		
Estonia	4,054	3,995	4,384	5,188	6,197	8,538		
Slovenia	10,724	9,595	9,905	11,088	13,900	16,450		
Croatia	4,371	4,206	4,458	5,138	6,508	7,705		
Romania	1,585	1,651	1,804	2,109	2,620	3,336		
Ukraine	631	634	777	870	1,044	1,472		
Kazakhstan	1,132	1,231	1,492	1,658	1,996	2,660		
EU25	19,779	18,262	18,335	19,986	24,201	27,481		
EU15	22,783	20,951	20,943	22,764	na	na		

(Source) EBRD (99-02) & EIU (03-04) for countries; EIU for EU25/15, GE, UK & FR; * own calculation (except for PO, HU, CZ & SK in 2003)

	1989	1990	1991	1992	1993	1994	1995	1996
Real GDP growth (%)								
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.0
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3
Czech Republic	1.4	-1.2	-11.6	-0.5	0.1	2.2	5.9	4.3
Slovak Republic	1.4	-2.5	-15.9	-6.7	-3.7	6.2	5.8	6.1
Lithuania	1.5	-5.0	-5.7	-21.3	-16.2	-9.8	3.3	4.7
Latvia	6.8	2.9	-10.4	-34.9	-14.9	2.2	-0.9	3.8
Estonia	8.1	-6.5	-13.6	-14.2	-8.8	-1.6	4.5	4.5
Slovenia	-1.8	-4.7	-8.9	-5.5	1.7	5.8	4.9	3.6
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	4.0
Ukraine	4.0	-4.0	-10.6	-9.7	-14.2	-22.9	-12.2	-10.0
Kazakhstan	-0.4	-0.4	-11.0	-5.3	-9.3	-12.6	-8.2	0.5
EU25	na	na	3.0	1.3	-0.5	2.8	2.4	1.7
OECD Total	3.8	3.1	1.3	2.1	1.3	3.3	2.5	3.1

	1997	1998	1999	2000	2001	2002	2003	2004
Real GDP growth (%)							*	**
Poland	6.8	4.8	4.1	4.0	1.0	1.4	3.8	5.5
Hungary	4.6	4.9	4.2	5.2	3.8	3.5	2.9	4.0
Czech Republic	-0.8	-1.0	0.5	3.9	2.6	1.5	3.1	4.0
Slovak Republic	4.6	4.2	1.5	2.0	3.8	4.4	4.2	4.8
Lithuania	7.0	7.3	-1.7	3.9	6.4	6.8	9.0	7.0
Latvia	8.3	4.7	3.3	6.9	8.0	6.4	7.5	7.5
Estonia	10.5	5.2	-0.1	7.8	6.4	7.2	5.1	5.5
Slovenia	4.8	3.6	5.6	3.9	2.7	3.4	2.3	4.1
Croatia	6.5	2.5	-0.9	2.9	4.4	5.2	4.3	3.7
Romania	-6.1	-4.8	-1.2	1.8	5.3	4.9	4.9	5.8
Ukraine	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.4	12.3
Kazakhstan	1.7	-1.9	2.7	9.8	13.5	9.8	9.2	9.0
EU25	2.6	2.9	2.9	3.7	1.7	1.1	0.9	2.3
OECD Total	3.6	2.7	3.3	3.9	1.0	1.7	2.2	3.4

(Source) EBRD Transition Report 2001-2004 (* estimate, ** projection); Eurostat & EIU (1991-1995 EU15, 1996-2004 EU25, 2004 est.); OECD (OECD Total, 2004 est.)

3. Inflation Rate

(Unit: %)

	1999	2000	2001	2002	2003	Housing Price Inflation		2004
Inflation rate (av; %)					A	B	(B/A)	
Poland	7.3	10.1	5.5	1.9	0.7	3.3	4.7	3.5
Hungary	10.0	9.8	9.2	5.3	4.7	7.6	1.6	6.8
Czech Republic	2.1	3.9	4.7	1.8	0.1	0.7	7.0	2.8
Slovak Republic	10.6	12.0	7.1	3.3	8.6	22.2	2.6	7.5
Lithuania	0.8	1.0	1.3	0.3	-1.2	0.3	na	1.2
Latvia	2.4	2.7	2.5	1.8	2.9	4.6	1.6	6.2
Estonia	3.3	4.0	5.8	3.6	1.3	3.2	2.5	3.0
Slovenia	6.1	8.9	8.4	7.5	5.6	5.7	1.0	3.6
Croatia	4.2	6.2	4.9	1.7	1.8	2.4	1.3	2.1
Romania	45.8	45.7	34.5	22.5	15.3		0.0	11.9
Ukraine	22.7	28.2	12.0	0.8	5.2		0.0	9.0
Kazakhstan	8.4	13.4	8.6	6.0	6.5	22.1	3.4	6.9
EU25	1.6	2.4	2.6	2.1	1.9	2.8	1.5	2.1
EU15						2.6		

(Source) EIU (inflation rate), Eurostat (housing price inflation except for CR&KZ) & Country Note on OECD Housing Finance Workshop in 2004 (CR&KZ: % change of annual average housing price)

4. Monthly Average Wages

(Unit: %, USD)

	1999	2000	2001	2002	2003	USD per month
Monthly average wages						
Poland	4.9	1.3	2.4	0.7	4.2	585.3
Hungary	0.6	3.4	8.4	12.4	7.0	612.0
Czech Republic	6.0	2.6	3.3	5.4	6.7	599.0
Slovak Republic [a]	7.3	6.6	8.2	9.2	6.3	493.8
Lithuania	4.9	-5.1	-0.3	3.8	9.3	430.0
Latvia	2.9	3.0	3.5	6.0	7.8	371.8
Estonia [b]	10.6	10.6	12.9	10.7	9.7	541.6
Slovenia [c]	3.3	1.6	3.3	2.0	1.9	1223.0
Croatia [d]	10.1	2.5	1.5	3.3	4.1	629.0
Romania	-1.1	0.9	10.7	2.2	9.0	219.0
Ukraine	-5.7	1.1	20.9	19.8	16.9	96.2
Kazakhstan	5.1	0.3	26.5	11.0	7.3	192.2
EU (euro area) [e]	2.7	2.7	2.8	2.5	2.4	2545.4 (EU15) [f]

(Source) EIU; average real wages; change as %, USD per month (2003)

[a] average nominal wages; [b] average; [c] gross real wages; [d] real net earnings; [e] employee compensation;

[f] Average monthly gross earnings in 2001 from Eurostat data "annual gross earnings", 3-25/2003) except for Germany and Ireland. Data in 2000 in Finland, France and Portugal

5. Unemployment Rate

(Unit: %)

	1999	2000	2001	2002	2003	2004
Unemployment rate (% of labour force)						
Poland	15.3	16.0	18.5	19.7	19.9	19.6
Hungary [a]	7.0	6.4	5.7	5.8	5.9	6.1
Czech Republic [b]	9.4	8.8	8.9	9.8	9.9	9.2
Slovak Republic [c]	19.2	17.9	18.6	17.8	15.2	14.3
Lithuania	14.1	16.4	17.4	13.8	10.3	6.8
Latvia [b]	9.1	7.8	7.7	8.5	8.6	8.7
Estonia	12.2	13.6	12.6	10.3	10.0	8.3
Slovenia	13.6	12.2	11.6	11.6	11.2	10.6
Croatia	19.1	21.2	22.0	22.3	19.5	18.7
Romania [c]	11.8	10.5	8.8	8.1	7.2	6.2
Ukraine	5.4	4.3	3.9	3.8	3.6	3.6
Kazakhstan	13.5	12.8	10.4	9.3	8.8	8.4
EU25 (ILO def.)	9.8	9.2	8.8	9.2	9.5	9.4

(Source) EIU; average data; (2004) estimate: CZ, SK, LAT, ROM & EU25

[a] EBRD (99-01 end-year) & EIU (02-04 av.); [b] EIU (99-02 end-year, 03-04 av.); [c] end-year

6. Household Consumption

(Unit: %)

Y2002	Housing	Food/Non-alcohole	Alcohole/ Tabacco	Transport	Recreation	Others
Poland	24.6	19.9	6.5	12.8	6.3	29.7
Hungary	18.4	19.4	8.3	15.0	7.8	31.1
Czech Republic [a]	22.8	18.8	8.9	10.5	10.9	28.1
Slovak Republic	23.1	22.1	5.8	9.5	9.1	30.4
Lithuania [a]	14.0	30.7	7.4	14.9	7.0	26.1
Latvia [a]	16.1	25.5	8.0	9.5	7.6	33.4
Estonia	21.0	22.9	8.7	11.3	7.5	28.6
Slovenia	20.0	17.2	4.8	14.9	9.5	33.7
EU25	21.1	13.2	3.8	13.6	9.5	38.7
EU15	21.0	12.8	3.6	13.7	9.6	39.3
United States	18.5	13.6	2.8	11.9	8.6	44.7

(Source) Eurostat; [a] data in 2000

7. Housing Stocks

Dwellings per 1000 inhabitants

	Unit/1000p	
United States	427.8	Y2001
EU15	452.7	
Austria	412.0	* Y2002
Belgium	415.0	* Y2002
Denmark	472.0	Y2002
Finland	499.0	* Y1999
France	503.0	Y2002
Germany	472.0	Y2002
Greece	505.0	* Y2001
Ireland	341.0	* Y2002
Italy	441.0	* Y1995
Luxembourg	394.0	* Y2002
Portugal	495.0	* Y2002
Spain	510.0	* Y2001
Sweden	484.0	* Y2002
Netherlands	417.0	* Y2002
United Kingdom	430.0	* Y2001
Study Countries av. [a]	388.8	
Poland	307.7	Y2002
Hungary	406.7	Y2001
Czech Republic	427.0	Y2001
Slovak Republic	320.6	Y2002
Lithuania	374.0	Y2002
Latvia	411.0	Y2002
Estonia	457.3	Y2002
Slovenia	393.2	Y2002
Croatia	417.3	Y2001
Rumania	373.0	Y2002
Ukraine	19775.5	Y1997
Kazakhstan	15600.0	Y1997

(Source) Bulletin of Housing Statistics for Europe and North America 2004, United Nations Economic Commission for Europe (UNECE)

* Housing Statistics in the European Union 2003, National Agency for Enterprise and Housing (NAEH), Denmark [a] except for Ukraine and Kazakhstan

Occupied dwellings by tenure

(Unit: %)

	Owner	Renter	Other	
United States	67	na	33	* Y1999
EU15	64	32	4	
Austria	57	40	3	Y2002
Belgium	68	31	2	Y2002
Denmark	51	45	4	Y2002
Finland	64	32	4	Y2002
France	56	38	6	Y2002
Germany	45	55	na	Y2002
Greece	74	20	6	Y2002
Ireland	80	20	na	* Y2002
Italy	68	32	na	* Y1991
Luxembourg	67	26	7	Y2002
Portugal	75	21	4	Y2001
Spain	81	11	8	Y2002
Sweden	46	39	15	Y2002
Netherlands	54	46	0	Y2002
United Kingdom	69	31	0	Y2002
Study Countries av.	80	15	5	
Poland	66.7	17	16	* Y2002
Hungary	89.6	10	na	* Y1996
Czech Republic	46.9	29	25	* Y2001
Slovak Republic	49.2	51	na	* Y2001
Lithuania [a]	90.9	7	na	* Y2001
Latvia	69.7	30	na	* Y2002
Estonia [b]	94.0	na	6	* Y1999
Slovenia	83.5	9	7	* Y2002
Croatia	na	na	na	
Rumania	94.0	4	2	** Y2002
Ukraine	100.0	na	na	* Y1998
Kazakhstan	93.2	7	na	* Y1997

(Source) NAEH; * UNECE; ** Country Note on OECD Housing Finance Workshop in 2004

[a] Sum of % differs from 100% due to dwellingswith unknowntenure status

[b] "Other" includes "rented-occupied" dwellings;

8. Housing Quality

Occupied dwellings by construction period

	Before 1919	1919-1945	1946-1970	1971-1980	1981-1990	1991-2000	2001 and later	
United States	8.6	17.6	25.8	20.1	14.4	13.6	na	Y1999
EU15	53.1			33.6		14.6		
Austria	18.3	8.4	28.1	16.0	12.7	16.6		Y2002
Belgium [a]	11.5	12.7	22.3	11.8	7.0	4.8	4.9	Y2001
Denmark	20.9	17.8	29.8	16.4	9.4	5.2	na	Y2002
Finland	1.7	8.8	30.6	23.4	19.9	12.3	2.1	Y2002
France	19.9	13.3	18.0	26.0	11.9	10.0	0.9	Y2002
Germany	8.0	6.0	57.9	10.2	3.0	7.5	na	Y1998
Greece	2.3	6.4	34.1	26.1	18.3	12.7		Y2001
Ireland	3.6	8.2	16.5	17.5	16.2	27.8	4.1	Y2002
Italy	19.0	10.5	40.7	19.7	10.1			* Y1991
Luxembourg	11.9	14.8	27.0	14.9	11.6	17.1	na	Y2001
Portugal	5.1	7.6	24.1	19.8	21.7	21.7	na	Y2001
Spain [b]	22.0	16.9	12.9	15.6	32.5			* Y2001
Sweden [c]	12.5	15.9	37.9	17.6	17.6	16.1		* Y2001
Netherlands	8.0	12.7	31.8	19.6	16.5	11.4		Y1999
United Kingdom	20.8	17.7	21.2	21.8	18.5			* Y2002
Study Countries av.	52.2			40.4		6.6		
Poland	10.1	13.0	26.9	18.3	20.9	7.7	1.1	Y2002
Hungary	15.0	13.5	27.3	22.0	18.1	4.0	na	Y2001
Czech Republic	51.9			38.9		9.2		** Y2003
Slovak Republic	3.4	6.6	35.1	25.6	21.0	6.2	0.6	Y2001
Lithuania	3.6	10.2	28.8	24.6	23.3	7.1	0.1	Y2001
Latvia	53.8			42.7		3.5		** Y2003
Estonia	54.0			41.0		5.0		** Y2003
Slovenia	51.9			40.2		7.9		** Y2003
Croatia [d]	47.6			40.5		8.4		** Y2003
Rumania	5.1	9.9	37.2	24.8	16.3	6.1	0.5	Y2002
Ukraine	69.0			26.2		4.8		** Y2003
Kazakhstan	na	na	na	na	na	na	na	

(Source) UNECE; * NAEH; ** Country Note on OECD Housing Finance Workshop in 2004

[a] (1991-2000) refers to (1991-1995), (2001 and later) refers to (1996 and later)

[b] (before 1991) refers to (before 1941), (1919-1945) refers to (1941-1960), (1946-1970) refers to (1961-1970)

[c] (before 1991) refers to (before 1921), (1919-1945) refers to (1921-1945)

[d] unknown: 3.5%

Average useful floor space of dwellings

	m^2	
United States	162.0	Y2001
EU15	91.9	
Austria	91.8	* Y2002
Belgium	86.3	* Y2001
Denmark	109.1	Y2002
Finland	76.8	* Y2001
France	89.6	Y2002
Germany	89.7	Y2002
Greece	82.7	* Y2000
Ireland	88.3	* Y2002
Italy	90.3	* Y2000
Luxembourg	125.0	* Y2000
Portugal	83.0	* Y2001
Spain	90.0	* Y2002
Sweden	90.6	* Y2000
Netherlands	98.0	* Y2000
United Kingdom	86.8	Y2001
Study Countries av.	67.8	
Poland	68.6	Y2002
Hungary	74.3	Y2001
Czech Republic [a]	84.4	Y2001
Slovak Republic [b]	56.1	Y2001
Lithuania	59.6	Y2001
Latvia	57.0	Y2002
Estonia	60.0	Y2000
Slovenia	113.5	Y2002
Croatia	na	
Rumania	45.0	Y2002
Ukraine	na	
Kazakhstan	59.1	Y2002

(Source) UNECE; * NAEH

[a] permanently inhabited dwellings only;

[b] average living floor space

Dwellings with equipments

(Unit: %)

	Piped water	Fixed bath or shower	Flush toilet	Central heating	Kitchen	
United States	99.2	99.5	99.5	88.6	96.0	Y2001
EU15	92.7	93.1	92.6	72.8	89.3	
Austria	99.9	98.1	99.0	89.5	100.0	Y2002
Belgium	87.5	71.3	67.0	12.7	82.7	Y2001
Denmark	na	94.4	98.1	98.5	97.5	Y2002
Finland	98.2	99.0	95.7	92.3	77.9	Y2002
France	na	98.0	na	91.0	na	* Y2002
Germany	na	na	na	91.0	na	* Y2002
Greece	98.1	92.3	92.6	56.3	77.6	Y2001
Ireland	97.0	94.0	96.0	59.0	100.0	Y2002
Italy	na	99.0	na	79.0	na	* Y1995
Luxembourg	na	94.2	92.0	92.3	na	Y2001
Portugal	68.5	65.6	na	3.8	na	Y2001
Spain	na	99.0	na	42.0	na	*Y1999/2000
Sweden	100.0	100.0	100.0	100.0	na	Y2002
Netherlands	na	100.0	na	90.0	na	* Y2002
United Kingdom	na	99.0	na	94.0	na	* Y2001
Study Countries av.	87.3	79.1	81.8	64.3	96.4	
Poland	95.6	87.0	88.1	77.8	92.0	Y2002
Hungary	84.6	79.9	80.4	na	na	Y1997
Czech Republic	86.4	83.7	82.2	64.5	na	Y2001
Slovak Republic	92.2	90.3	85.6	74.3	96.7	Y2001
Lithuania	74.9	67.8	73.5	70.2	na	Y2002
Latvia	83.0	66.9	78.0	64.9	99.0	Y2002
Estonia	84.3	67.1	74.6	59.0	96.3	Y2002
Slovenia	98.1	92.2	92.9	78.6	97.9	Y2002
Croatia	86.9	76.7	81.3	25.2	na	Y1997
Rumania	na	na	na	na	na	
Ukraine	na	na	na	na	na	
Kazakhstan	na	na	na	na	na	

(Source) UNECE; * NAEH

Households by useful floor space

(Unit: %)

	Under 50 m^2	50 m^2 to 74 m^2	75 m^2 to 99 m^2	100 m^2 to 149 m^2	150 m^2 and more	
United States	3.6	19.1		24.1	34.9	Y2001
EU15 [a]	10.7	53.9		35.3		
Austria	13.1	50.2		27.5	9.2	Y2002
Belgium	na	na	na	na	na	
Denmark	6.1	20.8	23.4	31.0	18.5	Y2002
Finland	na	na	na	na	na	
France	13.6	25.6	26.5	24.9	9.5	Y2002
Germany	11.2	31.5	22.6	25.7	9.1	Y2002
Greece	10.1	28.9	29.7	26.3	5.1	Y2001
Ireland	12.9	65.5		21.6		Y2002
Italy	7.9	52.7		29.5	9.0	Y1991
Luxembourg	na	na	na	na	na	
Portugal	na	na	na	na	na	
Spain	na	na	na	na	na	
Sweden	na	na	na	na	na	
Netherlands	na	na	na	na	na	
United Kingdom	na	na	na	na	na	
Study Countries av.	34.4	35.8	14.2	12.3	3.1	
Poland	35.6	33.1	12.0	13.2	6.0	Y2002
Hungary	17.2	38.3	22.7	18.6	3.3	Y2001
Czech Republic	17.7	40.6	22.2	14.5	4.1	Y2001
Slovak Republic	50.9	41.5	0.0	7.6	0.0	Y2001
Lithuania	na	na	na	na	na	
Latvia	na	na	na	na	na	
Estonia	na	na	na	na	na	
Slovenia	18.6	35.9	22.5	17.8	5.1	Y2002
Croatia	na	na	na	na	na	
Rumania	66.4	25.3	6.0	2.0	0.3	Y2002
Ukraine	na	na	na	na	na	
Kazakhstan	na	na	na	na	na	

(Source) UNECE

[a] EU7: Austria, Denmark, France, Germany, Greece, Ireland and Italy; average

9. New Construction

Dwellings completed per 1000 inhabitants

	Unit/1000p	
United States	5.2	Y1997
EU15	5.8	
Austria	5.2	Y2002
Belgium	3.5	* Y2002
Denmark	3.4	Y2002
Finland	5.2	Y2002
France	5.2	* Y2002
Germany	3.6	Y2002
Greece	9.9	Y2001
Ireland	14.7	Y2002
Italy	2.5	* Y2000
Luxembourg	3.7	* Y2002
Portugal	10.2	* Y2002
Spain	9.4	Y2002
Sweden	2.7	Y2002
Netherlands	4.1	Y2002
United Kingdom	3.1	* Y2002
Study Countries av.	1.9	
Poland	2.6	Y2002
Hungary	3.0	Y2002
Czech Republic	2.7	Y2002
Slovak Republic	2.6	Y2002
Lithuania	1.3	Y2002
Latvia	0.3	Y2002
Estonia	0.8	Y2002
Slovenia	3.6	Y2002
Croatia	2.7	Y1997
Rumania	1.3	Y2002
Ukraine	1.3	Y2002
Kazakhstan	0.7	Y2002

(Source): UNECE; * NAEH

Vacant dwellings

(Unit: %)

	Vacant	Occupied	
United States	8.4	91.6	Y2001
EU15	9.7	90.3	
Austria	0.0	100.0	Y2001
Belgium	na	na	
Denmark	4.7	95.3	Y2002
Finland	8.5	91.5	Y2002
France	6.8	93.2	Y2002
Germany	9.8	90.2	Y2002
Greece	35.4	64.6	Y2001
Ireland	0.5	99.5	Y2002
Italy	19.6	80.4	* Y2001
Luxembourg	2.3	97.7	Y2001
Portugal	30.7	69.3	Y2001
Spain	13.9	86.1	Y2001
Sweden	1.7	98.3	Y2001
Netherlands	2.0	98.0	Y2002
United Kingdom	0.0	100.0	Y2001
Study Countries av.	7.5	92.5	
Poland	0.0	100.0	Y2002
Hungary	0.3	99.7	Y2001est.
Czech Republic	12.3	87.7	Y2001
Slovak Republic	2.7	97.3	Y2001
Lithuania	6.9	93.1	Y2001
Latvia	7.0	93.0	Y2002
Estonia	13.4	86.6	Y2002
Slovenia	15.7	84.3	Y2002
Croatia	23.2	76.8	Y2001
Rumania	0.2	99.8	Y2002
Ukraine	na	na	
Kazakhstan	0.4	99.6	Y1997

(Source): UNECE; * NAEH

Residential and non-residential construction

	Residential	Non-residential	(Unit: %)
United States	49.0	51.0	Y2001
EU15	42.1	57.9	
Austria	12.0	88.0	Y2001
Belgium	44.5	55.5	Y1992
Denmark	37.8	62.2	Y2002
Finland	41.0	59.0	Y2002
France	47.8	52.3	Y2002
Germany	57.5	42.5	Y2002
Greece	36.0	64.0	Y1996
Ireland	49.3	50.7	Y2002
Italy	na	na	
Luxembourg	60.4	39.6	Y2001
Portugal	30.7	69.3	Y2001
Spain	51.0	49.0	Y2001
Sweden	38.5	61.5	Y2001
Netherlands	46.5	53.5	Y1996
United Kingdom	36.9	63.1	Y2001
Study Countries av.	21.2	78.8	
Poland [a]	16.2	83.8	Y2002
Hungary	28.9	71.1	Y1993
Czech Republic	na	na	
Slovak Republic [b]	37.0	63.0	Y2002
Lithuania	10.7	89.3	Y2002
Latvia	7.5	92.5	Y2002
Estonia	13.7	86.3	Y2002
Slovenia	49.7	50.3	Y2002
Croatia	13.1	86.9	Y2002
Rumania	na	na	
Ukraine	14.2	85.8	Y2001
Kazakhstan	na	na	

(Source): UNECE
[a] only construction units employing more than 9 persons
[b] preliminary data

New construction and private sector construction

	1993		1997		2001		2002	
	New const.	Private Sec.	New const.	Private Sec.	New const.	Private Sec.	New const.	Private Sec.
United States	1192.7	100.0	1400.5	100.0	1570.8	100.0	1648.4	100.0
EU15	109.9	85.2	109.8	85.5	123.4	90.0	138.4	87.8
Austria	35.5	67.2	48.4	69.2	38.1	72.5	34.2	72.8
Belgium	44.8	99.3	na	na	na	na	na	na
Denmark	14.1	56.0	17.7	68.9	16.7	80.2	18.1	72.9
Finland	30.0	93.3	26.0	96.3	30.0	100.0	27.0	100.0
France	287.0	na	282.6	na	310.0	na	334.0	na
Germany	404.4	98.0	515.6	98.6	292.3	98.7	259.9	98.5
Greece	61.3	100.0	72.3	100.0	91.6	100.0	na	na
Ireland	21.0	95.8	38.4	93.3	52.6	90.7	57.7	89.9
Italy	167.0	na	135.0	na	na	na	na	na
Luxembourg	3.3	na	2.3	na	2.3	na	na	na
Portugal	63.0	96.8	73.8	na	111.6	98.6	118.0	97.9
Spain	212.5	97.8	29.0	98.3	394.7	98.6	403.8	99.1
Sweden	35.1	68.1	13.0	72.8	15.4	83.1	19.9	77.4
Netherlands	83.7	70.7	92.3	72.8	73.0	81.2	66.7	80.4
United Kingdom	186.0	78.9	191.1	84.4	175.5	86.9	183.1	88.7
Study Countries av.	37.5	73.7	22.4	84.4	25.0	89.6	25.4	88.6
Poland	89.7	88.3	71.0	92.7	100.8	90.4	93.2	92.0
Hungary	18.5	94.3	24.6	97.5	24.8	96.4	28.3	93.3
Czech Republic	31.5	75.9	16.0	68.5	23.0	73.9	25.8	na
Slovak Republic [a]	14.0	84.2	7.2	69.6	10.3	88.3	14.2	83.1
Lithuania	8.2	68.8	5.6	93.2	3.7	97.4	4.5	97.8
Latvia	3.8	56.8	1.5	98.0	0.8	100.0	0.8	100.0
Estonia	2.4	91.7	1.0	100.0	0.6	100.0	1.1	90.9
Slovenia	7.7	89.9	5.7	86.9	6.1	84.4	7.0	74.0
Croatia	6.6	90.8	11.6	69.5	na	na	na	na
Rumania	30.1	63.9	29.9	88.2	27.0	94.4	27.7	88.1
Ukraine	189.0	42.3	80.4	73.4	65.6	74.4	64.4	73.9
Kazakhstan [a]	48.4	36.9	13.9	74.9	12.5	86.4	12.6	92.9

(Source) UNECE; new construction: number per 1000 units, private sector construction: % of total dwellings
[a] total dwellings completed (includes restoration, extention,conversion, etc.)

Average useful floor space per newly completed dwelling

(Unit: m^2)

	1993	1997	2001	2002
United States	182.5	180.0	193.7	194.9
EU15	100.0	103.2	103.7	100.0
Austria	95.7	92.8	101.1	na
Belgium	198.9	197.5	na	na
Denmark [a]	85.0	112.0	118.1	110.7
Finland [a]	80.3	80.7	87.6	89.3
France	94.4	104.7	111.5	112.6
Germany [a]	89.7	90.7	109.7	112.8
Greece	118.6	133.8	124.6	na
Ireland	86.3	87.5	87.7	88.4
Italy	92.3	87.4	na	na
Luxembourg	113.1	118.4	120.2	na
Portugal	75.5	71.3	82.6	90.3
Spain	91.1	92.7	96.1	96.1
Sweden	79.0	72.0	102.0	99.7
Netherlands	na	na	na	na
United Kingdom	na	na	na	na
Study Countries av.	84.1	102.4	118.1	116.7
Poland	81.1	93.3	86.0	99.3
Hungary	94.8	95.4	96.6	94.1
Czech Republic	94.0	103.0	106.6	104.9
Slovak Republic	114.8	105.5	129.1	117.8
Lithuania	73.3	109.2	101.8	100.9
Latvia	76.4	153.9	235.6	236.3
Estonia	74.0	121.2	114.2	99.2
Slovenia	102.1	105.4	118.4	113.5
Croatia	82.8	82.4	na	na
Rumania	71.6	82.9	103.4	104.9
Ukraine	65.1	79.6	90.5	94.3
Kazakhstan	79.7	96.8	116.5	118.2

(Source): UNECE; [a] average living floor space

ANNEX 2

FINDINGS FROM MARKET SURVEY ON HOUSING FINANCE IN TRANSITION ECONOMIES

1. Primary (Lending) Market

(1) Lender and Borrower Structure

(Unit: %)

	Commercial Banks	Mortgage Banks	Depository Institutions	Others	Total Lenders
Poland	96 (23)[a]	3	below 1	below 1	100
Total borrowers	100	100	100	100	
Individuals	70	20	100	0	
Corporations	30	80	0	100	
Others	0	0	0	0	
Hungary	44	48	8[c]		100
Total borrowers	100	100	100		
Individuals	99	99	100		
Corporations	1	1	0		
Others	0	0	0		
Czech Republic	72		28	(State Fund) n/a,	100
Total borrowers	100		100	100	
Individuals	76		99	n/a,	
Corporations	22		1	n/a,	
Others	2		0	n/a,	
Slovak Republic	87 (29)[b]		10	3	100
Total borrowers	100		100	100	
Individuals	95		98	92	
Corporations	5		2	9	
Others	0		0	0	
Lithuania	(commercial loans) 65			(soft loans) 35	100
Total borrowers	100			100	
Individuals	n/a,			n/a,	
Corporations	n/a,			n/a,	
Others	n/a,			n/a,	
Latvia	99.9 (17.7)[b]			0.1	100
Total borrowers	100			100	
Individuals	63.9			100	
Corporations	36.1			0	
Others	0			0	
Estonia	100 (84)[b]				100
Total borrowers	100				
Individuals	65				
Corporations	34				
Others	1				
Slovenia	100 (38)[b]		Contract savings scheme n/a	National Housing Fund n/a	100
Total borrowers	100		100	100	
Individuals	n/a,		n/a,	n/a,	
Corporations	n/a,		n/a,	n/a,	
Others	n/a,		n/a,	n/a,	
Croatia	98.6		1.4		100
Total borrowers	100		100		
Individuals	48.86		100		
Corporations	40.55		0		
Others	10.59		0		
Romania	98.8	1.2	(started in May 2003) n/a,	(stopped in Feb 2003) n/a,	100
Total borrowers	100	100	100	100	
Individuals	62.2	100	n/a,	97.5	
Corporations	37.8	0	n/a,	2.5	
Others	0	0	n/a,	0	

Ukraine	95		4	1	100
Total borrowers	100		100	100	
Individuals	n/a,		n/a,	n/a,	
Corporations	n/a,		n/a,	n/a,	
Others	n/a,		n/a,	n/a,	
Kazakhstan	60 (87.7)[b]			40	100
Total borrowers	100			100	
Individuals	100			100	
Corporations	0			0	
Others	0			0	

(Notes) Data in 2003 (3Q 2004 in Hungary; 2002 in Lithuania; 30 June 2004 in Croatia; 1 Jan 2005 in Kazakhstan)
[a] ( ): Share of mortgage loans to the total loans of non-financial banking sector (2002)
[b] ( ): Share of mortgage loans to the total banking housing loans (Latvia: residential and commercial mortgages to banking assets)
[c] Including savings cooperatives

(2) Major Lenders

	Commercial Banks	LTA	**Mortgage Banks**	**Depository Institutions**	**Others**
Poland	1. PKO BP SA	35%	1. Rheinhyp-BRE	1. Kasa Mieszkaniowa PKO SA	1. National Housing Fund [a]
	2. BPH PBK SA	14%	2. Hypovereinsbank	2. Kasa Mieszkaniowa BPH	2. Mortgage Fund (non-active)
	3. PEKAO SA	10%	3. ING Śląski Mortgage Bank	3. Kasa Mieszkaniowa ING Bank Śląski	
	[total banking sector] *	8.8%	4. Nykredit (Denmark)		
	Total Number	** 57	***Total Number*** 4	***Total Number*** 3	***Total Number*** 2
Hungary	1. K&H Bank	n/a,	1. OTP Mortgage Bank	[Contract savings institutions] 1.OTP Building Society (domestic) 2. Fundamenta (foreign) [Savings cooperatives] - more than 100 savings coops	Since 2001, insurance companies are entitled to engage in mortgage financing. No loans initiated so far. Currently act as a syndicated partner of a mortgage bank.
	2. OTP Bank	n/a,	2. FHB		
	3. Erste	n/a,	3. HVB Mortgage Bank		
	[total banking sector]	12%			
	Total Number	12	***Total Number*** 3	***Total Number*** 2 + over 100 coops	***Total Number*** 2
Czech Republic	1. Ceskomoravska hypotecni banka	91%		1. Ceskomoravska stavebni sporitelna	1. State Housing Development Fund
	2. Ceska sporitelna	74%		2. Stavebni sporitelna České sporitelny	
	3. Komercni banka	61%		3. Vseobecna stavebni sporitelna	
	[total banking sector]	71%			
	Total Number	10		***Total Number*** 6	***Total Number*** 1
Slovak Republic	1. Slovenská sporiteľňa, a.s.	n/a,		1. Prvá stavebná sporiteľňa, a.s.	1. State Housing Development Fund
	2. Všeobecná úverová banka, a.s	n/a,		2. VÚB Wüstenrot, a.s.	
	3. Tatrabanka, a.s.	n/a,		3. ČSOB stavebná sporiteľňa, a.s.	
	[total banking sector]	n/a,			
	Total Number	10		***Total Number*** 3	***Total Number*** 1
Lithuania	1. Hansabankas	n/a,			Bustas program (soft loan subsidised via the national fund) (data in 2002)
	2. Vilniaus bankas	n/a,			
	3. Sampo bankas	n/a,			
	[total banking sector]	n/a,			
	Total Number	n/a,			
Latvia	1. Hansabanka	12%			Credit Unions (0.001%share) 32
	2. Unibanka	10%			Insurance companies 17
	3. Parex bank	6%			
	[total banking sector] [c]	11.3%			
	Total Number	23			***Total Number*** 49
Estonia	1. Hansabank	17%			
	2. Eesti Ühispank	19%			
	3. Nordea Bank	25%			
	[total banking sector]	18%			
	Total Number	7			
Slovenia	n/a,			1. National Housing Savings scheme	1. National Housing Fund
	[total banking sector]	31%			
	Total Number	n/a,		***Total Number*** n/a,	***Total Number*** n/a,
Croatia	1. Zagrebacka banka	n/a,		1. Prva Stambena Stedionica D.D.	
	2. Privredna banka Zagreb	n/a,		2. Raiffeisen Stambena Stedionica D.D.	
	3. Erste&Steiermaerkische bank	4.6%		3. Wuestenrot Stambena Stedionica D.D.	
	[total banking sector]	8.5%		4. PBZ Stambena Stedionica D.D.	
	Total Number	33		***Total Number*** 4	
Romania	n/a,		1. Domenia Credit	1. Raiffeisen Banca pentru Locuinte (housing bank) (established in May 2003)	1. National Housing Agency (stopped its lending activity in Feb 2003)
			2. IMO Credit		
			(mortgage companies)		
	[total banking sector]	n/a,			
	Total Number	17	***Total Number*** 2	***Total Number*** 1	***Total Number*** 1

Ukraine	1. JSPPB AVAL	19%		Arkada bank (The bank tries to develop CSS but CSS does not so work in Ukraine.)	Credit Unions (0.5-1.0% share)
	2. Privat bank	13.6%			
	3. Ukrsibbank	13.1%			
	[total banking sector]	75%			
	Total Number	10		***Total Number*** 1	***Total Number*** n/a,
Kazakhstan[b]	1. Kazkommertsbank OJSC	14%			1. BTA Mortgage Company OJSC
	2. Bank TuranAlem OJSC	11%			2. Astana Finance OJSC
	3. Central Credit Bank OJSC	10%			
	[total banking sector]	n/a,			
	Total Number	13			***Total Number*** 2

(Notes) Data in 2003 (* June 2004, ** Sept 2004); LTA is the ratio of housing loan debts to the total bank assets.
[a] The Fund is located in the National Economy Bank (Bank Gospodarstwa Krajowego).
[b] KMC (Kazakhstan Mortgage Company) redeems mortgage loans from its partners (commercial banks and non-banks) for securitization.
[c] Loans to households for purchase, construction or renovation of housing property.

(3) Typical Loan Products

	Type of Loan	Interest Rates	Maturities	Borrowers	LTV [a]
Poland	1. Fixed rate mortgage	Av. 7.4%	20-25 years		40-60%
	PKO BP SA "Wlasny kat"	7.58% ~ (PLN)	≦30 years	Households	≦100%
	BPH PBK SA	1.65% ~ (CHF)	≦32.5 years	Households	≦100%
	2. Fixed & floating rate mortgage				
	PEKAO SA	5.55%: fixed in 1st year, then WIBOR 3M+margin (PLN)	≦25 years	Households	≦100%
	3. Dual indexed mortgage	Adjustable rate			
Hungary	1. Fixed rate mortgage	Interest rate+ handling fee (subsidised): 4.95% (+1.5%) - 10%(+2%), fixed for 1, 5years	15-20 years ≦25 years	Households	Typical: 40-50% ≦60,70%
	2. Floating rate mortgage	CHF interest rate + handling fee: 2.49% (+2.5%) - 3.99% (+2.5%), CHFLIBOR 3M,6M,1Y	≦30 years	Households	Typical: 40-50% ≦60-80%
	3. Differed payment mortgage	Adjustable rate			
Czech Republic	Fixed rate mortgage	Av. 5.2%			Av. 47%
	Private mortgage	2.99-7%	5-30 years	Rich & middle-income households	≦70%
	Corporate mortgage	3.5-8%	5-20 years	Corporations	≦70%
	Municipal mortgage	3-7%	5-30 years	Municipalities	≦70%
Slovak Republic	Fixed rate mortgage	7-9%			
	Private mortgage	n/a,	4-30 years	Rich & middle-income households	≦70%
	Municipal mortgage	n/a,	4-30 years	Municipalities	≦70%
Lithuania	Floating rate mortgage	VILBOR(LTL)/ EURIBOR(EUR)/ LIBOR(USD) 3M-1Y + fixed margin	15-25 years	Households Corporations	
	Soft loan (subsidised loan)		20 years & more		≦95% [b]
	Commercial loan		10 years		≦80%
Latvia	Fixed & floating rate mortgage				
	Mortgage loan for purchase, construction or renovation of housing property	Fixed: 5-8% (LVL) Floating: RIGIBOR 6M + 1.5-3.5% (LVL)	10-40 years ≦40 years	Households (also non-profit institutions serving households)	75-90% ≦100%
	Commercial mortgage		≦15 years	Housing cooperatives and condominiums	80% ≦100%
Estonia	Floating rate mortgage				
	Housing loan	3-5%	≦40 years	Households	75-90%
	Investment loan	4-5%	≦20 years	Corporations	50-80%
Slovenia	1. Fixed rate mortgage	Fixed for 2 or 5 years, then negotiable rate	10-20 years (over 20y: rare)	n/a,	33-60%
	2. Floating rate mortgage (inflation linked loan)	EURIBOR based	n/a,	n/a,	n/a,
Croatia	1. Zagrebačka banka	6.80-7.50% (EUR)	20-30 years	Households	≦100%
	2. Privredna banka	6.98-7.48% (EUR)	20-25 years	Households	≦100%
	3. Erste & Steiermärkische Bank	6.45-6.95% (EUR)	20-30 years	Households	≦100%
		4.99% (CHF)	20 years	Households	≦100%
Romania	1. Fixed rate mortgage				
	Raiffeisen Bank	25% (ROL), 9.5% (EUR, USD)	20 years	Households	75%
	2. Floating rate mortgage				
	Domestic commercial banks	25% (ROL), EURIBOR+7bp, LIBOR+8bp	20 years	Households	75%
	BRD- Group Societe Generale	25% (ROL), EURIBOR+7.5bp, LIBOR+7.5bp	20 years	Households	75%

Ukraine	Fixed rate mortgage				
	Housing mortgage	12-15%	3-15 years	Households Corporations	75% 50%
	Commercial mortgage	12-15%	1-5 years	Corporations	50%
	Ground mortgage (planned) [c]				
Kazakhstan	Refinanced mortgage (Loan redeemed by KMC)	13.6% (12.6% in some KMC partners)	≦20 years	Low-& middle-income households	70-90%

(Notes) Data in 2003 (2002 in Lithuania; June 2004 in Croatia)

[a] LTV (loan-to-value ratio): % of the mortgage lending value or the market value

[b] Up to 95% of the property value with mortgage insurance, up to 85% for a new house without any insurance

[c] The mortgage on agricultural lands will be available from 1 Jan. 2008, when the moratorium on the sales of lands is supposed to be abolished.

(4) Loan Conditions

(Unit: %)

	1999	2000	2001	2002	2003	2004
Poland						*
Average Lone-to-value ratio	20-40	20-40	30-50	30-50	40-60	40-60
Default rate [a]	8.6	6.4	6.4	7.2	6.7	4.9
Mortgage interest rate	n/a,	n/a,	n/a,	n/a,	7.4	n/a,
Long-term credit rate	n/a,	n/a,	n/a,	10.5	7.9	7.6
Hungary						*
Average Lone-to-value ratio	n/a,	n/a,	n/a,	n/a,	n/a,	40-50
Default rate	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Mortgage interest rate [b]	n/a,	18.4	16.4	14.2	12.2	12.3
Long-term credit rate	n/a,	9.0	8.5	7.7	7.6	9.2
Czech Republic						*
Average Lone-to-value ratio	46	40	48	48	47	47
Default rate	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Mortgage interest rate	7.35	8.45	6.91	6.11	5.16	4.78
Long-term credit rate	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Slovak Republic						
Average Lone-to-value ratio	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Default rate	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Mortgage interest rate	n/a,	n/a,	n/a,	8.45-9.95	7-9	n/a,
Long-term credit rate	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Lithuania						
Average Lone-to-value ratio	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Default rate	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Mortgage interest rate	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Long-term credit rate [c]	n/a,	n/a,	7.82 (Dec)	5.55(May)	n/a,	n/a,
Latvia						
Average Lone-to-value ratio	n/a,	n/a,	n/a,	n/a,	n/a,	below 70 [d]
Default rate	n/a,	n/a,	n/a,	n/a,	n/a,	1.6
Mortgage interest rate	n/a,	n/a,	n/a,	n/a,	n/a,	6.1
Long-term credit rate	15.2	12.4	11.0	8.2	6.5	n/a,
Estonia						
Average Lone-to-value ratio	60	65	65	70	70	75
Default rate	n/a,	3.9	3.7	2.2	1.2	0.6
Mortgage interest rate	9.3	10.0	7.3	6.7	5.2	4.0
Long-term credit rate	9.2	10.1	7.7	6.7	3.9	4.4
Slovenia						
Average Lone-to-value ratio	n/a	n/a	n/a	n/a	n/a	n/a
Default rate	n/a	n/a	n/a	n/a	n/a	n/a
Mortgage interest rate	n/a	n/a	n/a	n/a	n/a	n/a
Long-term credit rate	n/a	n/a	n/a	n/a	n/a	n/a
Croatia						*
Average Lone-to-value ratio	n/a	n/a	n/a	n/a	n/a	n/a
Default rate	n/a	n/a	n/a	n/a	n/a	n/a
Mortgage interest rate	10.0	9-9.5	9-9.5	7.5-9	6.9-8.9	6.8-8.5
Long-term credit rate	n/a	n/a	n/a	n/a	n/a	n/a
Romania						
Average Lone-to-value ratio	n/a	n/a	n/a	n/a	n/a	n/a
Default rate	n/a	n/a	n/a	n/a	n/a	n/a
Mortgage interest rate	n/a	n/a	n/a	n/a	n/a	n/a
Long-term credit rate	n/a	n/a	n/a	n/a	n/a	n/a

Ukraine						
Average Lone-to-value ratio	n/a,	n/a,	n/a,	n/a,	70	70-80
Default rate	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Mortgage interest rate	18	16	14	14	12	11
Long-term credit rate	43.3	33.0	26.1	18.6	17.8	15.4
Kazakhstan						
Average Lone-to-value ratio	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Default rate	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Mortgage interest rate	n/a,	18.2	16.1	14.4	14.5	13.7
Long-term credit rate	n/a,	25.6	19.3	20.7	n/a,	n/a,

(Notes) * June 2004

Mortgage interest rate is an average (or typical) rate of most popular fixed rate housing mortgage loan with longest maturity, provided by the major mortgage lender. Long-term credit rate is an average (or typical) interest rate of longest-term loan provided by major commercial bank.

[a] Share of claims classified irregular (non-financial sector)

[b] Annual average rate without subsidy

[c] bank loans over 5 years

[d] below 70% for more than a half of housing loans

(5) Housing Loans Outstanding

(5-1) By Lender

(Unit: mil. national currency)

	1999	2000	2001	2002	2003	2004
Poland	11,602.7	15,901.8	21,166.0	27,237.3	38247.9	* 42,787.4
Commercial Banks	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Mortgage Banks	n/a,	n/a,	n/a,	n/a,	n/a,	2,778
Depository Institutions	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Hungary	129,302	190,821	327,230	787,257	1,518,711	1,910,000
Commercial Banks	108,579	138,674	231,408	432,022	661,189	849,632
Mortgage Banks	691	8,140	25,552	250,351	715,115	980,230
Depository Institutions	20,032	51,333	70,270	104,884	142,407	152,138
- Contract savings institutions	462	2,548	5,127	15,169	16,913	17,601
- Savings cooperatives	19,570	48,785	65,143	89,715	125,494	134,537
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Czech Republic [a]	7,423	13,024	31,689	47,153	76,390	117,411
Commercial Banks	7,423	13,024	31,689	47,153	76,390	117,411
Mortgage Banks						
Depository Institutions	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Slovak Republic [a]	570	1,446	3,903	9,250	18,938	* 32,509
Commercial Banks	570	1,446	3,903	9,250	18,938	32,509
Mortgage Banks						
Depository Institutions	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Lithuania	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Commercial Banks	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Mortgage Banks						
Depository Institutions						
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Latvia	56.8	111.5	235.9	404.9	784.4	1,392.2
Commercial Banks	56.8	111.5	235.9	404.7	783.6	1,391.0
Mortgage Banks						
Depository Institutions						
Others	0.0	0.0	0.0	0.2	0.8	1.2
Estonia	7,311	8,680	11,770	15,593	23,107	36,680
Commercial Banks	7,311	8,680	11,770	15,593	23,107	36,680
Mortgage Banks						
Depository Institutions						
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Slovenia (USD million)	58.6	55.4	79.1	179.4	336.1	n/a,
Commercial Banks	26.1	19.2	32.2	56.5	113.0	n/a,
Mortgage Banks						
Depository Institutions	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	0	0	0	3.6	0	n/a,

Croatia	7,469.5	8,258.4	9,461.6	12,454.7	17,084.1	* 18,697.0
Commercial Banks	7,469.5	8,257.8	9,450.0	12,363.4	16,896.2	18,425.7
Mortgage Banks						
Depository Institutions		0.6	11.6	91.3	187.9	271.2
Others						
Romania (EUR million)	n/a,	n/a,	n/a,	200	405	n/a,
Commercial Banks	n/a,	n/a,	n/a,	175	400	n/a,
Mortgage Banks (companies)	n/a,	n/a,	n/a,	0	5	n/a,
Depository Institutions	n/a,	n/a,	n/a,	0	0	n/a,
Others	n/a,	n/a,	n/a,	25	0	n/a,
Ukraine [a]	n/a,	n/a,	317.5	676.3	2,287.0	2,951.0
Commercial Banks	n/a,	n/a,	317.5	676.3	2,287.0	2,951.0
Mortgage Banks						
Depository Institutions	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Kazakhstan [b]	n/a,	n/a,	n/a,	n/a,	259,434	503,515
Mortgage loans	n/a,	n/a,	n/a,	n/a,	228,976	441,449
Loans redeemed by KMC	n/a,	n/a,	63.82	1,033.79	7,938.04	22,191.31
Commercial Banks	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Mortgage Banks						
Depository Institutions						
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,

(Notes) Year-end data; * June 2004

[a] Commercial banks only [b] Year-end data refers to the data on 1 Jan next year.

(5-2) By Borrower

(Unit: mil. national currency)

	1999	2000	2001	2002	2003	2004
Poland	11,602.7	15,901.8	21,166.0	27,237.3	38247.9	* 42,787.4
Individuals	5,853.2	9,572.6	14,067.9	19,668.3	28,982.3	32,892.2
Corporations	5,749.5	6,329.2	7,098.1	7,563.6	9,256.0	9,878.5
Others	0.0	0.0	0.0	5.4	9.6	16.7
Hungary	129,302	190,821	327,230	787,257	1,518,711	1,910,000
Individuals	129,302	190,821	327,230	787,257	1,518,711	1,910,000
Corporations	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Czech Republic	7,423	13,024	31,689	47,153	76,390	117,411
Individuals	n/a,	n/a,	26,136	38,606	66,812	105,286
Corporations	n/a,	n/a,	2,981	5,199	5,901	8,297
Others	n/a,	n/a,	2,572	3,384	3,677	3,828
Slovak Republic	570	1,446	3,903	9,250	18,938	* 32,509
Individuals	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Corporations	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Lithuania	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Individuals	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Corporations	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Latvia	56.8	111.5	235.9	404.9	784.4	1,392.2
Individuals	n/a,	74.5	123.8	237.6	487.5	889.0
Corporations	n/a,	37.0	112.1	167.3	296.9	503.2
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Estonia	7,311	8,680	11,770	15,593	23,107	36,680
Individuals	3,388	4,504	6,111	9,431	15,233	23,893
Corporations	3,880	4,156	5,603	6,083	7,739	12,437
Others	43	20	57	79	135	350
Slovenia (USD million)	58.6	55.4	79.1	179.4	336.1	n/a,
Individuals	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Corporations	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Croatia	7,469.5	8,258.4	9,461.6	12,454.7	17,084.1	* 18,697.0
Individuals	7,469.5	8,258.4	9,461.6	12,454.7	17,084.1	* 18,697.0
Corporations	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,

Romania (EUR million)	n/a,	n/a,	n/a,	200	405	n/a,
Individuals	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Corporations	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Ukraine	n/a,	n/a,	317.5	676.3	2,287.0	2,951.0
Individuals	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Corporations	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Kazakhstan	n/a,	n/a,	n/a,	n/a,	259,434	503,515
Individuals	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Corporations	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Others	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,

(Notes) Year-end data (Kazakhstan: data on 1 Jan next year); * June 2004

(5-3) New Lending

(Unit: mil. national currency)

	1999	2000	2001	2002	2003	2004
Poland	n/a,	n/a,	n/a,	9,000	33,700	* 3,400
Hungary	n/a,	n/a,	164,000	513,000	781,000	505,000
Czech Republic	n/a,	n/a,	24,810	30,310	47,597	68,126
Slovak Republic	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Lithuania	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Latvia	n/a,	n/a,	n/a,	n/a,	n/a,	579.7
Estonia	3,397	4,490	5,801	8,197	12,395	20,690
Slovenia (USD million)	26.1	19.2	32.2	56.5	113.0	n/a,
Croatia	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Romania	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Ukraine	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Kazakhstan	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,

(Notes) Year-end data; * June 2004

(6) Mortgage Insurance

	Private Mortgage Insurance			**Public (Government) Mortgage Insurance**	
		Ratings[a]	Functions		Functions
Poland	1. TU EUROPA SA	n/a,	Default insurance	n/a,	n/a,
	2. CIGNA STU	n/a,	Default insurance		
Hungary	n/a,	n/a,	n/a,	State guarantee [b]	Default insurance
Czech Republic	n/a,	n/a,	n/a,	n/a,	n/a,
Slovak Republic	n/a,	n/a,	n/a,	n/a,	n/a,
Lithuania	n/a,	n/a,	n/a,	JSC Housing Loan Insurance [c]	Default insurance
Latvia [d]	n/a,	n/a,	n/a,	n/a,	n/a,
Estonia	n/a,	n/a,	n/a,	The Estonian Credit and Export Guarantee Fund, KredEx	Default insurance
Slovenia	n/a,	n/a,	n/a,	n/a,	n/a,
Croatia	n/a,	n/a,	n/a,	n/a,	n/a,
Romania	n/a,	n/a,	n/a,	n/a,	n/a,
Ukraine [e]	n/a,	n/a,	n/a,	n/a,	n/a,
Kazakhstan	"Kazakhinstrakh JSC", etc (17 companies)	n/a,	Default insurance	Mortgage Guarantee Fund of Kazakhstan JSC	Default insurance

(Notes) [a] Company ratings by Standard & Poor's, Fitch, Moody's, etc.
[b] For high LTV loans, the target groups: civil servants, and young families since 1 Feb 2005.
[c] Issued 20-23% of the total commercial residential mortgages in Oct 2002.
[d] Real estate insurance exists. [e] There are life insurance, insurance to borrowers' work capacity, real estate insurance and title insurance.

(7) Contract Savings Schemes (CSS)

(Unit: %, mil. national currency)

	1999	2000	2001	2002	2003	2004
Poland						*
Average deposit rate (%)	4.75	5.37	3.50	2.00	2.00	2.00
Average lending rate (%)	9.50	10.75	7.00	4.00	4.00	4.00
Total housing savings	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Government subsidies [a]	145.9	130.2	n/a,			
Total housing loans by CSS	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Hungary						*
Average deposit rate (%)	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Average lending rate (%)	6	6	6	6	6	6
Total housing savings	40,008	65,708	94,256	151,219	146,425	167,325
Government subsidies	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Total housing loans by CSS	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Czech Republic						
Average deposit rate (%)	2-4.5	2-3	2-3	1-3	1-3	1-2.95
Lending rate range: bridge loans (%)	6.8-13.5	6.5-11	6.4-11	4.5-11.4	4.5-10.4	3.9-9.5
Lending rate range: loans (%)	5-7.5	5-6	5-6	3.9-6	3-6	3-5.95
Total housing savings	93,629	110,400	133,309	180,190	236,815	287,044
Government subsidies	6,393	7,719	9,313	11,059	13,261	15,337
Total housing loans: bridge loan	17,930	16,804	18,501	24,392	38,498	63,511
Total housing loans: loans	8,416	14,207	18,522	21,916	25,099	46,250
Slovak Republic (USD million)						
Average deposit rate (%)	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Average lending rate (%)	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Total housing savings	931.8	936.0	948.8	828.1	n/a,	n/a,
Government subsidies [b]	139.5	139.5	104.7	93.0	n/a,	n/a,
Total housing loans by CSS	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Lithuania						
Latvia						
Estonia						
Slovenia						
Average deposit rate (%)	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Average lending rate (%)	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Total housing savings	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Government subsidies	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Total housing loans by CSS	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Croatia						
Average deposit rate (%)	2-3	2-3	2-3	2-3	2-3	2-3
Average lending rate (%)	5-6	5-6	5-6	5-6	5-6	5-6
Total housing savings	87.6	437.8	1,137.5	2,012.9	3,265.2	* 3,477.7
Government subsidies	n/a	68.94	n/a	203.2	273.0	320.8 [c]
Total housing loans by CSS		0.6	11.6	91.3	187.9	* 271.2
Romania						
Average deposit rate (%)	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Average lending rate (%)	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Total housing savings	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Government subsidies	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Total housing loans by CSS	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Ukraine						
Average deposit rate (%)	20.7	13.5	11.2	7.8	7.1	7.8
Average lending rate (%)	n/a,	n/a,	24.8	22.1	17.9	17.5
Total housing savings	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Government subsidies	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Total housing loans by CSS	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Kazakhstan						

(Notes) Year-end data; * June 2004

[a] Tax relief: the amount of deductions from tax due in contract savings system. The tax relief was abandoned in 2002.

[b] Sum per client/year (USD) [c] Planned in the State Budget for 2005 (to be paid for the requests from 2004)

2. Secondary (Funding) Market

(1) Funding Instruments

(Unit: %)

	Mortgage Bonds (mortgage covered bonds)	Mortgage Backed Securities (MBS)	Contract Savings Schemes	Others	Total Fundings
Poland	below 1		below 1	(short-term deposits) 98	100
Hungary	99		1		100
Czech Republic	48		52		100
Slovak Republic	n/a,		n/a,		100
Lithuania				(deposits(LTL)) 100	100
Latvia	4.5			(deposits [a]) 95.5	100
Estonia				100	100
Slovenia			n/a,	(short-term deposit) n/a,	100
Croatia			100	(deposits [b]) n/a,	100
Romania			100	(deposits [c]) n/a,	100
Ukraine [d]			n/a,	(deposits [e]) n/a,	100
Kazakhstan	100				100

(Notes) Data in 2003 (2002 in Lithuania); [a] Banks' and non-banks' deposits, mostly short-term
[b] FX household's deposits, EBRD selective deposits, equity capital of banks, etc.
[c] Short-term deposits, special funds by EBRD, IFC and DEG
[d] The law "on mortgage securities" has yet to be accepted (under arrangement).
[e] Mostly short-term deposits, sometimes special funds by EBRD, World Bank, etc.

(2) Mortgage Bonds

(2-1) Instruments

	Interest Yields	Maturities	LTV limit of pooled mortgage	Remarks
Poland	WIBOR 6M+mergin	3-10 years	60% of the mortgage lending value	mortgage covered bonds public sector bonds
Hungary	7.0-8.0%	3-10 years	60% of the mortgage lending value (av. 40-42%)	mortgage covered bonds
Czech Republic	2.7-7.5%	5-7 years	70% of the market value	mortgage covered bonds
Slovak Republic	9.32%	5-11 years	70% of the mortgage lending value	mortgage covered bonds public sector bonds
Lithuania				
Latvia	3.76-3.90% (USD) 3.75-5.75 (LVL)	3-10 years	60 / 75% of the market value	mortgage covered bonds
Estonia				
Slovenia				
Croatia				
Romania				
Ukraine				
Kazakhstan	Floating (rate is decided twice a year.) (2nd FX period:max.4.5%)	n/a,	n/a,	Collateralised mortgage bonds by mortgage loan pools / limited inflation risk by means of "cap" and "floor" etc.

(Note) Data in 2003

(2-2) Mortgage Bonds Issuance and Outstanding

(Unit: mil. national currency)

		1999	2000	2001	2002	2003	2004
Poland	Issuance	n/a,	18.48	90.75	222.75	853.42	* 968.22
	Outstanding	n/a,	18.48	90.75	222.75	853.42	* 968.22
Hungary	Issuance	2,040	6,680	19,136	259,908	757,442	587,181
	Outstanding	2,820	9,500	28,636	288,544	922,006	1,220,292
Czech Rep.	Issuance	11,400	5,850	1,850	9,350	17,900	20,880
	Outstanding	16,500	24,850	24,900	33,150	52,150	59,530
Slovak Rep.	Issuance	200	600	1,350	2,500	10,700	** 13,300
	Outstanding	n/a,	n/a,	n/a,	n/a,	n/a,	n/a,
Lithuania							
Latvia	Issuance	0.5	3.8	3.7	10.6	7.6	17.4
	Outstanding	0.5	4.4	8.0	17.6	23.6	40.0

		1999	2000	2001	2002	2003	2004
Estonia							
Slovenia							
Croatia							
Romania							
Ukraine							
Kazakhstan	Issuance [a]			0	1,500	8,000	25,000
	[placed] [a]			[0]	[1,500]	[7,700]	[17,931]
	Outstanding[b]			0	1,656 (2)	11,156 (6)	54,503 (14)

(Notes) Year-end data; * September 2004; ** June 2004; [a] Mortgage bonds issued and placed by KMC [b] ( ): Total issuance amount

(2-3) Issuer Structure

Poland	Share	Hungary	Share	Czech Republic *	Share	Slovak Republic	Share
Rheinhyp-BRE	93.7%	OTP Mortgage Bank	64%	Komercni banka	13.4%	Slovenská spotiteľňa	n/a,
Hypovereinsbank	5.0%	FHB	31%	Ceska sporitelna	33.5%	Všeobecná úverová banka	n/a,
ING Śląski Mortgage Bank	1.3%	HVB Mortgage Bank	5%	Ceskomoravska hypotecni banka	41.9%	Tatrabanka	n/a,
				HVB	11.2%	Istrobanka	n/a,
						HVB bank	n/a,
						OTP	n/a,
						ČSOB	n/a,
						UNIbanka	n/a,
Total	100%	Total	100%	Total	100%	Total	100%
Lithuania	Share	**Latvia**	Share	**Estonia**	Share	**Slovenia**	Share
		Mortgage and Land Bank of Latvia	94.7%				
		Baltic Trust Bank	5.3%				
		Total	100%				
Croatia	Share	**Romania**	Share	**Ukraine**	Share	**Kazakhstan**	Share
						1. Kazakhstan Mortgage Company	95%
						2. Bank Center Credit	2%
						3. BTA-Mortgage Company	2%
						4. Lariba Bank	1%
						Total	100%

(Notes) Data in June 2004; * Data in 2003

(2-4) Investor Structure

Poland *	Share	Hungary	Share	Czech Republic	Share	Slovak Republic	Share
Bank (BRE)	53%	Foreign Investors (IFIs)	32%	Banks	72.7%	Individuals	n/a,
Foreign investors [a]	22%	Pension Funds	21%	Individuals	15.45%	Banks	n/a,
Trust Funds	17%	Investment Funds	17%	Insurance companies	8.25%	Insurance companies	n/a,
Insurance Companies	6%	Credit Institutions	11%	Others	3.6%	Pension funds	n/a,
Others	2%	Insurance Companies	10%			Foreign investors	n/a,
		Households	7%			Others	n/a,
		Others	2%				
Total	100%	Total	100%	Total	100%	Total	100%
Lithuania	Share	**Latvia**	Share	**Estonia**	Share	**Slovenia**	Share
		Banks	60%				
		Insurance companies	20%				
		Pension funds	10%				
		Individuals	5%				
		Others	5%				
		Total	100%				
Croatia	Share	**Romania**	Share	**Ukraine**	Share	**Kazakhstan** **	Share
						Pension funds	53%
						Commercial Banks	43%
						Insurance companies and others	4%
						Total	100%

(Notes) Data in 2003; * Data in 2002 [Data on 30 Nov. 2003 (Fitch Polska): Banks 40.35%; Domestic investors 31.54%; Foreign investors 28.11%]
** Data in Dec. 2004; [a] EBRD (international org.) 16% and HypoVereinsbank (German HVB Group) 6%

3. Government Support (Government Subsidies)

		Poland		Hungary		Czech Republic		Slovak Republic	
			STB		STB		STB		STB
Interest bonuses on savings		Yes	0.3%	Yes	0.1%	Yes	1.6%	Yes	0.9%
Subsidies on interest payments on mortgage loans		Yes	0.1%	Yes	0.6%	Yes	0.1%	Yes	0.2%
Personal income tax benefits		Yes	3.0%	Yes	0.3%	Yes	0.2%	No	
Down payment subsidies		No		No		Yes	0.7%	No	
Construction subsidies		Yes	0.2%	Yes	0.8%	Yes	(both)	Yes	0.5%
Others		Yes	0.3%	No		No		Yes	0.3%
Total cost of government support measures for housing **		(mil. PLN)	1,902.7						
	% of national budget		1.2%		1.9%	*	2.3%		2.8%
	% of GDP		0.2%		0.9%	*	0.7%		n/a,
Government spending for other social policies									
Education	% of national budget		5.1%		12.0%	*	12.0%		n/a,
	% of GDP		1.0%		5.8%	*	3.6%		n/a,
Health care	% of national budget		1.8%		10.0%	*	6.2%		n/a,
	% of GDP		0.4%		4.9%	*	1.9%		n/a,

		Lithuania		Latvia		Estonia		Slovenia	
			STB		STB		STB		STB
Interest bonuses on savings		No		No government support available		Yes	n/a,	Yes	n/a,
Subsidies on interest payments on mortgage loans		Yes [a]	n/a,			Yes	n/a,	n/a,	n/a,
Personal income tax benefits		Yes [b]	n/a,			Yes	0.4%	n/a,	n/a,
Down payment subsidies		Yes [c]	n/a,			No		n/a,	n/a,
Construction subsidies		n/a,	n/a,			No		n/a,	n/a,
Others		Yes [d]	n/a,			Yes [e]	n/a,	n/a,	n/a,
Total cost of government support measures for housing									
	% of national budget		n/a,		n/a,		0.1% [f]		n/a,
	% of GDP		n/a,		n/a,		n/a,		n/a,
Government spending for other social policies									
Education	% of national budget		n/a,		5.10%		12.0%		n/a,
	% of GDP		n/a,		1.68%		n/a,		n/a,
Health care	% of national budget		n/a,		14.52%		13.4%		n/a,
	% of GDP		n/a,		4.79%		n/a,		n/a,

		Croatia		Romania		Ukraine		Kazakhstan	
			STB		STB		STB		STB
Interest bonuses on savings		Yes	2.18%	Yes	n/a,	No	n/a,	No	
Subsidies on interest payments on mortgage loans		No		No		Yes	n/a,	No	
Personal income tax benefits		Yes	n/a,	No		Yes	n/a,	No	
Down payment subsidies		Yes	n/a,	No		Yes	n/a,	No	
Construction subsidies		No		No		Yes	n/a,	No	
Others		No		Yes [g]	n/a,	Yes	n/a,	No	
Total cost of government support measures for housing [h]									
	% of national budget		n/a,		7.2%		1.3%		n/a,
	% of GDP		n/a,		2.3%		0.3%		n/a,
Government spending for other social policies [i]									
Education	% of national budget		5.7%		11.2%		n/a,		14%
	% of GDP		2.8%		3.6%		n/a,		3%
Health care	% of national budget		15.4%		11.9%		n/a,		8%
	% of GDP		7.6%		3.8%		n/a,		2%

(Notes) Data in 2003 (2002 in Lithuania); * % of the State budget expenditure in 2002
STB is the ratio of subsidies to the total budget (government spending).
[a] It was scheduled to end on 31 Dec 2002. Since then, no information.
[b] Residential mortgage interest tax deduction
[c] The Social Benefit (BS) provides a cash payment to low-income households.
[d] The Utility Compensation (UC) covers heating and water related costs in some conditions.
[e] Guarantees to certain groups of the population aiming to lower downpayment
[f] "Housing and community amenities" include mainly KredEx guarantees.
[g] NHA subsidy programs (households who buy a new house: 20%) , state subsidy for the completion of buildings started before 1990 (up to 30% of the housing value), state subsidy for young people (till 30-y old) and disabilities, etc.
[h] Including housing and community amenities [i] Not including self-financing institutions

4. Regulations (Legal Framework)

	Poland	Hungary	Czech Republic	Slovak Republic
Mortgage laws and related regulations (to ensure property (real estate) as a mortgage)	Yes	Yes	Yes	Yes
Laws and regulations on property registration (to make sure of property rights for owners)	Yes	Yes	Yes	Yes
Laws and regulations on specialised mortgage lending institutions (mortgage banks) (principle of specialised bank)	Yes	Yes	No (only license)	No (only license)
Laws and regulations on depository (savings) institutions	Yes	Yes	Yes	Yes
Laws and regulations on private mortgage insurers	No	No	No	No
Laws and regulations on secondary mortgage facilities (MBS)	Yes	No	No	No
Laws and regulations on transactions of mortgage bonds (mortgage covered bonds)	Yes	Yes	Yes	Yes
Foreclosure laws and related regulations	Yes	Yes	Yes	No
Others	n/a,	n/a,	n/a,	n/a,

	Lithuania	Latvia	Estonia	Slovenia
Mortgage laws and related regulations (to ensure property (real estate) as a mortgage)	Yes	Yes	Yes	Yes
Laws and regulations on property registration (to make sure of property rights for owners)	n/a,	Yes	Yes	Yes
Laws and regulations on specialised mortgage lending institutions (mortgage banks) (principle of specialised bank)	No	No	No	No
Laws and regulations on depository (savings) institutions	No	Yes	No	Yes
Laws and regulations on private mortgage insurers	No	No	No	No
Laws and regulations on secondary mortgage facilities (MBS)	No	No	No	No
Laws and regulations on transactions of mortgage bonds (mortgage covered bonds)	No	Yes	No	No
Foreclosure laws and related regulations	n/a,	Yes	Yes	Yes
Others	n/a,	Yes [a]	n/a,	n/a,

	Croatia	Romania	Ukraine	Kazakhstan
Mortgage laws and related regulations (to ensure property (real estate) as a mortgage)	No	Yes	Yes	Yes
Laws and regulations on property registration (to make sure of property rights for owners)	Yes	Yes	Yes	Yes
Laws and regulations on specialised mortgage lending institutions (mortgage banks) (principle of specialised bank)	No	Yes	No	Yes
Laws and regulations on depository (savings) institutions	Yes	Yes	Yes	Yes
Laws and regulations on private mortgage insurers	No	No	No	Yes
Laws and regulations on secondary mortgage facilities (MBS)	No	No	No	Yes
Laws and regulations on transactions of mortgage bonds (mortgage covered bonds)	No	No	No	Yes
Foreclosure laws and related regulations	Yes	Yes	Yes	Yes
Others	Yes [b]	n/a,	n/a,	n/a,

(Notes) Data in 2004 (2002 in Lithuania) [a] Laws and regulations on financial instruments and securities [b] Banks law (Zakon o bankama), etc.

Reference: Exchange Rate to USD

		1999	2000	2001	2002	2003	2004
Poland	(PLN: Zloty)	4.2	4.3	4.0	3.9	3.74	2.99
Hungary	(HUF: Forint)	252.5	284.7	279.0	225.2	* 224.3	* 202.7
Czech Republic	(CZK: Koruna)	35.7	38.8	36.5	30.7	* 28.21	* 25.70
Slovak Republic	(SKK: Koruna)	42.1	48.6	48.2	41.1	33.0	28.5
Lithuania	(LTL: Litas)	4.0	4.0	4.0	3.3	2.76	2.55
Latvia	(LVL: Lats)	0.58	0.61	0.64	0.59	* 0.57	* 0.54
Estonia	(EEK: Kroon)	15.6	16.7	17.6	14.9	12.41	12.80
Slovenia	(SIT: Tolar)	196.8	235.6	250.9	226.2	* 207.1	* 192.4
Croatia	(HRK: Kuna)	7.6	8.2	8.4	7.1	* 6.70	* 6.03
Romania	(ROL: Leu)	18255	25926	31597	33500	41115	39351
Ukraine	(UAH: Hryvna)	5.2	5.4	5.3	5.3	* 5.33	* 5.32
Kazakhstan	(KZT: Tenge)	138.2	144.5	150.2	154.6	144.2	130.0

(Source) EBRD Transition Report 2004 (1999-2002), Economist Intelligence Unit Country Reports(2003-2004); end-year, * year-average

Part II

HOUSING FINANCE MARKETS IN SELECTED TRANSITION ECONOMIES

CHAPTER 1. HOUSING FINANCE IN POLAND

by
Karol Skiba*

1. Macroeconomic Characteristics

Demographic trends and indicators

The population of Poland has been on a slightly upward trend since the transition period and reached the level of 38.19 million in 2003 as compared to 37.88 million in 1988 (an increase of 306 thousand – 0.8%). Although the rise in the total number of population was insignificant in statistical terms, the total number of households in the same period grew by 13.1% from 11.97 million in 1988 to 13.54 million in 2003. However the average household size decreased by 10.2% mostly as a result of a rise in the number of single-person households (an increase of 6.9 basis points in the same period).

Economic trends and outlook in the medium term

During recent months, Poland's economy has shown signs of a gradual recovery. The average GDP growth was above 5% in 1997-99. Annual GDP growth in 2003 amounted to 3.8% (as against 1.4% in 2002). In the fourth quarter of 2004 as compared to the same period of previous year GDP amounted to 5.3%. The prime reason for this recovery was an increase in domestic demand[1], although not supported by an alteration of unfavourable trends in the employment absorptive capabilities of economy. Moreover, the growth continued to be propped up by export yet now as a result of appreciation of PLN as against EUR (the Euro-zone countries are the Polish main export destination routes), the share of export in GDP is being marginalized.

Consumer price growth in 2002 was slower than in the previous year. Annual CPI inflation (December-on-December) stood at 0.8% (compared to 3.6% in 2001). Annualised average inflation came to 1.9% (compared to 5.5% in 2001). In 2004, annualised average price growth was higher than in the same period of 2003 (3.5%, as against 0.8%), furthermore twelve-month consumer inflation (December-to-December) was running at 4.4% (compared to 1.7% in 2003).

The official interest rates of the National Bank of Poland were cut down six times in 2003, by a total of one and a half percentage point (reference rate), which led to a fall in both the lending and deposit rates offered by the banks to their customers and in the yields on basic money market instruments. In 2004, the Monetary Policy Council increased interest rates three times as a result of inflationary pressure related, among other things, to EU accession and now the basic interest rate stands at 6.5% (central bank reference rate).

Average monthly employee earnings in the corporate sector went up by 5.6% in the fourth quarter of 2004 (as compared to the same period the previous year), to stand at 2,405 zloty (gross).

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The exchange rate for the US dollar at the National Bank of Poland amounted to 3.7405 zloty as at the end of December 2003, with the EUR established at 4.7170 zloty. On the 31st December 2004, in comparison to previous year, the zloty gained both a nominal 20.5% to the dollar and 13.53% to the EUR.

The situation in the labor market has not yet improved. At the end of 2002, the jobless total amounted to over 3.21 million (up by 3.2% on the previous year), while the rate of unemployment stood at 20.2%. At the end of June 2004 the unemployment rate reached 19.5% (compared to 19.7% a year earlier).

2. Demand and Supply of Housing

The total housing stock in Poland at the end of 2003 amounted to 12.6 million dwellings[2]. In years 1997-2003 the average rate of the housing assets increase was about 0.9% a year. The average usable floor area of a dwelling is currently 68.8 m^2 and was steadily growing since transition period due to a significant increase of the average usable floor area of completed dwellings, especially in individual construction. The same trend was recorded in the average usable floor area per capita. In 2003 the respective index was 29.7% above the 1990 value. The number of dwellings per 1000 inhabitants as at the end of 2003 reached almost 330. Yet despite gradual improvement, the ratio still lags behind the average of European Union countries.

Recently the unfavorable conditions in respect to the level of satisfied housing need, which negatively distinguish Poland among other European countries, have progressively increased. The intensity of housing production seems to be the major reason behind the scale of housing arrears.

With regard to the legal title of housing assets, during the period of 1988-2002[3] significant proprietary alterations took place. It stemmed from conversion of rental title to the dwelling – which was predominant prior the transition period – into the ownership right. The results of the census of 2002 revealed that over 55% of inhabited dwellings constituted a separate ownership of natural persons (individuals). The detailed specification as refers to tenure structure is in table below.

Table 1: Tenure structure in 2002

	Total inhabited dwellings (in thousand)	Dwellings which belong to:						
		Natural persons	Co-operative	Municipalities	State Treasury	Enterprises	Social housing association	Others
Total	11,763.5	55.2%	28.6%	11.5%	1.7%	2.2%	0.4%	0.4%

Source: Based upon census data

Additionally, the census of 2002 exposed housing deficit slightly larger than previously predicted (calculated as a difference between the number of households and the number of the total housing assets) as it grew in 2002 to the level 947, 600 dwellings. Notwithstanding the statistical deficit of dwellings (as a difference between the number of households and the number of inhabited dwellings) amounted to 1,567,000 and was about over 314,000 dwellings higher when compared to 1988 figures.

However "the statistical deficit of dwellings" overstates both the dimension of real housing needs and effective demand for housing (it fails to incorporate into calculations the income generated by households). Additionally, the category of housing deficit does not point to the number of households who co-habit and then arrive at a decision to live on their own (the differences could be substantial). As a result the approach, which base upon the simplified assumption of permanent housing crisis in Poland fails to be supported by social expectations and real potential of housing market. On the other hand, the Central Statistical Office expects the total number of households to grow at a significant rate, which could be translated into acceleration of housing needs in the future. Those factors contribute to the conclusion that the assessment of housing needs seem to be performed with prudent approach.

The level of unsatisfied housing needs is not the only factor which testifies about the upscale of demand in housing sector. A spimilar situation relates to housing conditions, which in comparison to other European Countries present itself exceptionally poor. In Poland, as an average one dwelling consists of 3.70 rooms where live 3.25 persons (most Central Europe Countries depict their housing conditions more favorable). As a consequence the spatial conditions of housing fall short of 23 square meters per capita.

In terms of average age of dwellings, Poland is doing relatively well even when compared to the Western European countries. The oldest part of the housing stock, i.e. constructed before 1918 accounted only for 10% of the total while 49% of the stocks are dwellings built after 1970. Respective figures for the Western European countries were 15% and 40%. Unfortunately, due to poor technologies and significant rehabilitation backlog, the deterioration of dwellings is often very high even in relatively new stock.

The value (equipment with amenities and technical standard) of existing dwellings is by all means related to their legal title as well as the age of buildings they are situated in. The severe amortization of existing housing assets corresponds mainly with municipal stock (also privatized dwellings in MHS buildings) as well as part of older stock located mostly in rural areas. Low annual level of general repairs coupled with insufficient rental incomes will additionally increase already high rate of technical amortization of that housing stock.

Definitely, the predominant legal form of housing supply is the segment of separate ownership construction (averaged at over 85% of total housing output in recent years). Exceptional adaptive features of this market are not a new phenomenon in Poland. Yet in the period of centrally-planned economy the output of co-operative tenancy construction (the segment backed by several active forms of state assistance), at least two times outnumbered the ownership construction, which used to suffer from financial limitations as well as administrative restrictions. The fundamental obstacle which restricts the demand for dwellings in new ownership segment is a significant disparity of potential purchasers' income and the high prices of dwellings. The purchasing power, expressed as a ratio of net monthly salary to a price of a square meter of usable floor is limited to 0.7 – 0.9 square meter depending on the region.

On the supply side, there is still a problem of serviced land for housing. The infrastructure is the responsibility of the municipalities, which lack the budgetary resources for necessary investments. As a result, overall cost of residential development is higher (either final tender prices for serviced land are higher or cost of construction is transferred onto investors).

Regarding housing output, in 1997 a severe breakdown of dwellings completed was reversed and the number of residential units was more than 73 thousand or about 18% above the 1996 figures. Data for years 1998-2003 confirmed the upward trend in housing. In 2003 162,700 dwellings were completed, which means an increase of 66.7% in comparison to the results of 2002 (see table below). The most dynamic growth was recorded in the new types of housing i.e. in dwellings for commercial sale or rent (8.5%) as well as in dwellings constructed by social housing associations (25.8%). Moreover , individual investors completed over 118 thousand dwellings (125.1% more as compared to 2002 results) yet the boom finds its explanation not only in statistical terms.

Table 2: New construction (in thousand)

		1999	2000	2001	2002	2003
Housing starts		81.9	87.8	105.9	97.6	162.7
	Multi-family	48.6	52.3	65.3	45.2	44.6
	Single-family	33.3	35.5	40.6	52.4	118.1
Construction source structure						
	Private sector	75.9	81.8	96.8	90.3	154.7
	Public sector	2.6	1.9	2.3	2.5	1.9
	Housing associations**	3.4	4.1	6.8	4.8	6.1
Housing trading volume (in thousand unit)						
	Primary market	n/a,	n/a,	n/a,	n/a,	n/a,
	Secondary market*	320.6	270.3	262.3	243.2	n/a,

* Estimated data

** Non-profit organizations of which 65% are owned or co-owned by municipalities

Despite large housing needs, annual output of the housing construction industry is still insufficient. In 2001, slightly more than 2.7 newly completed dwellings per 1000 inhabitants were offered on the market while this figure amounted to 2.6 in 2002. Despite an increase of the analysed ratio in 2003 to almost 4.3, such favourable change was caused by a sharp up-growth of dwellings completed by private investors. The reason behind it was expected fines for utilizing a dwelling/house without a filed notification of completed investments. Private investors, who had already finished construction works, delivered a notification to the building authorities, thus avoided penalties and accelerated the number of completed dwellings in 2003.

The size of the rental sector in Poland has been diminishing over the decade. There are several factors shaping the process. New construction is dominated by owner-occupancies: individual, cooperative and provided by developers on profit basis. The tenure structure is also affected by the privatisation of the existing units (sale to sitting tenants – see tables below). The relatively high dynamics of the privatisation is due to considerable discounts offered to buyers, which are typically 80% of the market value and higher.

Table 3: Privatised dwellings in buildings owned or co-owned by municipalities or employers

	1995	1999	2000	2001	2003
- *Dwellings in buildings owned or co-owned by municipalities total (thousands of units)*	2 035.3	1 999.9	1 929.5	1 828.7	1 314.8
- *share of privatised dwellings*	14.8%	27.1%	28.9%	30.1%	n/a
- *Dwellings in buildings owned or co-owned by employers total (thousands of units)*	1 155.3	754.2	676.3	616.7	466.9
- *share of privatised dwellings*	6.2%	18.2%	19.8%	21.6%	n/a

Central Statistical Office (2002 data not available)

Table 4: Co-operative rental and cooperative owner-occupied dwellings

	1988	1996	1998	1999	2000	2001	2002	2003
Coop dwellings total *(thousands of units).*	2 800	3 204.6	3 329.3	3 350.2	3 386.8	3 410.4	3 369.1	3 452.2
of which:								
- coop rental	2 333.0	1 416.6	1 285.7	1 185.1	1 156.7	1 060.3	1 097.5	1 127.5
	83.3%	44.2%	38.6%	35.4%	34.1%	31.1%	32.6%	32.6%
- coop owner-occupied	467	1 788.0	2 043.6	2 165.1	2 230.1	2 350.1	2 271.6	2 323.7
	16.7%	55.8%	61.4%	64.6%	65.9%	68.9%	67.4%	67.4%

Central Statistical Office

3. Housing Finance Market and System

The first half of the 90's did not see a great demand for mortgage loans. There were many reasons for this and some of them were strictly related to macroeconomic performance of Poland. The most important of them were as follows:

1. High cost of loans,

2. Low demand for long-term, market-priced, loans in circumstances of economic uncertainty,

3. Low housing affordability as an effect of the negative relation between households' income, mortgage rates and construction costs.

Yet the situation has completely altered now and according to calculations of National Bank of Poland at the end of first half of 2004 total housing loan outstanding in the whole banking system amounted to 43,446.3 million zlotys. This amount comprises of the sum of housing loan outstanding of individuals that constituted over 77% (33,547.0 million zlotys) and housing loan outstanding of corporations (9,899.3 million zlotys).

Almost 51% of total housing loans outstanding constituted denominated housing loans (22,081.4 million zlotys). With regard to housing loans granted to individuals the ratio is even higher as at the end of June 2004 it amounted to 59% (19,759.2 million zlotys).

Mortgage loans including housing loans are one of the most dynamically developing banking products in recent years, as only in the period of second half of 2000 and second half of 2004 the total housing loan outstanding of households increased over 3.5 times (over 26.2 billion zlotys). Thus the annual growth rate in the same period averaged at over 6.5 billion zlotys. (see also Appendix 1)

Significant housing loan dynamic has been accompanied by considerably low interest rate of denominated loans, additionally supported by a sharp drop of interest of loan in Polish currency in last two years. At the end of first half of 2004 the market-driven interest rate on housing loans in zloty was circa 7.4%.

The first half of 2004 witnessed the prices of dwellings, in both primary and secondary markets, increasing, to some extent as a result of implementation of basic (22%) VAT rate on building materials (previously 7%). Additionally, the increase of prices was caused by a surge in demand, which find its explanation in the anxiety of purchasers about eventual price perturbation following EU accession. The expected further increase of demand for housing loans by mortgage loan providers will probably confirm the upward trend of prices in housing market. In the light of several analyses of real estate brokers it is foreseeable that in the period of oncoming months the prices of housing will increase by 5-7%.

The dynamic growth in value of granted housing loans, which is observed at present, coupled with a more flexible loan policy of mortgage loans providers, indicates that the banks intensively compete to gain over the higher possible share in the market. More flexible loan policy combined with the improvement of income of households as well as the increase of demand for loan have the features of pro-cyclical behavior, which can escalate the amplitude of economic cycles in future.

The influence of the present high growth rate of housing loans on the situation of banks (as well as indirectly on situation of the whole economy) in longer horizon will considerable depend upon the measure of the loan risk management by banks.

At present, the quality of loans for property purposes including especially housing loans is much better than the average quality of loans for non-financial sector. However, the features of loans for property purposes do not allow an unambiguously affirmation that they imply low level of risk. The horizon of repayment performance (usually 20-25 years) as well as short period of offering such financial products by banks indicates that the cycle of worsening of housing loans is not fully well-known.

The high growth rate of housing loans as well as the uncertainty which accompany the future quality of loan portfolio forced the banking supervision to implement[4] the principles of prudent valuations of loan collateral as well as to introduce the acceptable relation of loan to the value of property being credited (benchmark of 50% of LTV indicator). The higher share of loan is acceptable yet proper relation between bank equity and credit risk exposure should be maintained.

Until recently housing construction was financed almost exclusively with cash (excluding subsidized loans of pre-transition years and early 1990s). In 1998 the share of loans in housing financing accounted for about 9%. In 1999 the figure has risen to 15% while in 2000 and 2001 amounted to 16% and 21% respectively. In 2002 the analyzed figure reached almost 24%. Two years ago the share of housing loans in property financing increased additionally by 4 basic points.

In terms of mortgage insurance, the market has not yet developed to the extent which would satisfy both lenders and borrower of housing loans. Housing loan insurance resolves to limited assistance of granted credit maturity of which expires at the date of registration in land and mortgage book. Yet recently the insurance market has witnessed a new product, which is exclusively directed at enhancing borrowers' opportunities in the event of inadequate amount of equity. However, as a rule the insurance company adapts the products to the requirements of a bank depending upon banking procedures being in force in a given bank.

4. Secondary Mortgage Market

In 1997 the Act on Mortgage Bonds and Mortgage Banks was adopted. It introduced a German model of mortgage securitization - *Pfandbrief*. Mortgage banks are specialised financial institutions with the right to issue mortgage bonds (*Pfandbrief*) against the mortgages in their portfolio. Mortgage bonds, which are long-term safe capital market instruments, are supposed to provide suitable long-term financing for mortgage loans originated by mortgage banks and have positive impact on their interest and maturity. There are currently four mortgage banks in Poland:

1. HypoVereinsbank (since 26th November 2004 BPH Mortgage Bank),
2. Rheinhyp (since 1st January 2005 BRE Mortgage Bank),
3. Slaski Mortgage Bank,
4. Nykredit.

With regard to the number of banks operating in Poland, as well as the dimension of market they can serve, the set up of four mortgage banks up till now cannot be recognized as a fulfillment of hopes placed in the Law. Universal banks with the largest housing loan portfolio (PKO BP S.A., Pekao S.A.) have not yet set up theirs mortgage banks. Additionally Pekao S.A. despite being authorized by Banking Supervision abandoned the idea of launching the project of mortgage bank.

As a result, the perspective of expansion of mortgage loan market seems still not to have fully explored opportunities for dynamic participation of mortgage banks in the market. After several years of activity the share of the banks in mortgage loan market is still marginal. As at the first half of 2003 the portfolio of mortgage loans which finance the property acquisition reached almost 3% of total value of property loan portfolio in the whole banking sector. Moreover the issuance of mortgage bonds at an aggregate amount of 437 million zlotys, constitute only 1% of total amount of commercial debt securities. (see also Appendix 2)

Commonly expressed obstacles as refers to the development of that market are as follows:

1) Necessity of creation the mortgage loan portfolio which distinguish itself by a proper quality being at the same time the basis for the issuance of mortgage bonds,

2) Legal limitation (for a time being) of investors' activity in capital market,

3) Long lasting procedures of registration in land and mortgage books.

On the other hand, the foundation of the housing financial system based on secondary mortgage market has emerged. The legal basis in that respect is the amendment to the Law *on banking* (2004), which introduces the name "securitization" to legal environment, as well as the approved also in 2004 the Law *on investment funds*, which defines the principles of securitization funds. It is advisable to mention here that yet legally stipulated now, the securitization was previously applied to several market transactions.

Nevertheless, the majority of the housing loans currently offered by Polish banks are still funded with short-term deposits. However, it should be noted that securitization would, to some extent, improve the affordability of mortgage financing. The considerable narrow spread on loans and deposits justifies the application of alternative financial techniques by banks, rather than extend the depositary policy actions.

5. Regulations

Land and Mortgage Books

A key legal institution for the property trade in Poland is the land and mortgage books. Land and mortgage books are registers kept for each individual property by regional courts. They consist of information on the property itself (plot number, address, area, etc.) and on its legal status (i.e. its present owner, mortgages and other encumbrances or third parties rights).

In January 2003 a pilot program of electronic system of land and mortgage books system was launched in 6 courts in Poland. The process of introduction of electronic system is lead within the framework of PHARE 2000, the aim of which is to create an integrated cadastral system.

The initiation of the electronic land and mortgage book system has taken place so far in 30 sections of land and mortgage books in selected regional courts. In November 2004 additional 18 sections of land

and mortgage books were expected to be covered by electronic system. Moreover as early as in January 2005 the total number of regional courts, which benefit from being subject of electronic system of land and mortgage book, will amount to 66.

It is estimated that electronic system of land and mortgage books will cover all regional courts in the period of 10 to 12 years.

The new system should dramatically cut down on the time needed to register title or mortgage, thus making the market safer and accelerating property transactions. Investors and creditors will have basic property data available from the central information office without needing to obtain them from local courts. As changes will be entered promptly, the contents of electronic land and mortgage books will be more up to date and reliable than now.

Notary fees

In June 2004 the notary services fees have been cut down as a result of introduction the amendment to the ordinance *on the maximum notary fees*. As a result the property transactions have taken advantage of lower cost, although the alteration cannot be addressed as revolutionary.

6. Housing Policy

As the most recent government strategy in respect to housing policy had envisaged the introduction of legal environment relating to the housing investment process (the elimination of the legal and administrative bottlenecks) the new law on spatial planning was approved by the Parliament in 2003. It has created a legal basis for more coherent spatial planning process and standardization of spatial documents in order to achieve a higher essential quality. Moreover, it has simplified spatial procedures as well as rationalized the localization of investments of public-purposes. However, the idea of replacing out-of-date general and local plans was highly indispensable. The lack of financial means caused the municipalities to suspend work defining new spatial development plans.

As a result in September 2004 The Ministry Council conditionally accepted the draft Law *on municipal spatial development*. The basic foundation of the draft Law is the urgent introduction of new solutions, which aim at covering by local spatial development laws the whole land areas of municipalities. The targeted system of spatial development in municipalities is expected to rely upon three different kinds of local laws which define the purposes of land areas and the principles of development – the local plans of spatial development:

1. *The plan of purpose* – the basic law obligatory prepared for the whole land area of municipality which determines the purpose of the land areas,

2. *The plan of development* – similarly detailed as the present local plan, is defined for the land area previously determined in the plan of purpose, which requires the transformation of planning structure,

3. *The municipal planning and architectural regulations* – regulate both local principles of building location and its dimension; are prepared for land area defined in the plan of purpose.

On the other hand, the main reason for implementation of amendment to Building Law (approved also in 2003) was to introduce the significant simplifications in the pre-feasibility study as well as on operation stage of the investment project. The most relevant alterations are as follows:

(a) Simplification and acceleration of administrative procedures in construction process,

(b) Introduction of legalization opportunities related to lawless built structure,

(c) Introduction of compulsory inspections of completed structures,

(d) Modification of the scope of competences of public administration bodies.

Yet in September 2004 the Ministry Council conditionally accepted the draft amendment to Building Law in order to facilitate the regulations to altering construction environment.

The draft Law embraces, among other things the following groups of amendments:

The facilitations for investor related to:

1) Elimination of obligation to obtain building permit or to notify the construction related to infrastructure terminals,

2) Elimination of group of experts which deal with the alignment of project specification (the scope of competences is to be transferred to county foremen).

Since the middle of 1990's, one of the government housing policy priorities has been development of affordable rental housing co-financed by preferential loan granted from National Housing Fund resources. Now the new amendment of the act which regulates such issues as well as the ordinance to the act was introduced to legal environment. The alterations included in the acts aim at implementation of measures to enhance the performance of legislative regulations e.g. simplification and acceleration of the procedures of preferential loan approval granted to investors.

In terms of new regulations, the government has recently introduced a program of *Housing construction for people who require social assistance*. It intends to both support those families which live on the brink of poverty and prevent the phenomenon of homelessness. The completed initiation of the program is planned following 2005. Till the acceptance of systemic solutions and proclamation of new law, the assistance to municipalities will be granted within the framework of pilot program. According to pilot program, the financial assistance will be directed to municipalities and rely upon the idea of financial support of projects related to renovation and alteration of residential buildings as well as the revision of utilization the non-for-housing building in order to facilitate social units as well as shelter for homeless.

Beside outlined above programs, there are other housing policy tools such as:

- Tax relief for individuals (see additional information):

  - Taxpayer's right to deduct part of the expenditures for renovation and modernisation of dwellings and single-family houses from tax due,

  - Taxpayer's right to deduct interest paid on a housing loan from taxable income,

- Preferential rates of value added tax for selling dwellings as well as for construction renovation and alteration services (see Additional information),

- Low-interest (fixed rate) long-term credit for housing purposes,
- Thermal modernisation program,
- System of assistance for tenants with lower incomes (housing allowances),
- Preferential credit for municipalities, granted from National Housing Fund resources. The purpose of the credit is to finance municipal infrastructure related to housing construction,
- Assistance for those repaying the so-called cooperative "old-portfolio loans",
- Guaranteed bonuses for owners of saving-for-housing booklets,
- Preferential housing loan for natural disasters victims,
- Contract saving system[5].

Last but not least, in April 2004 Lower Chamber of Polish Parliament –Sejm – passed the Law *on National Plan of Development*, which will form the strategy embracing the country development actions for the period of 2007-2013. Additionally NPD will refer to the actions being outside the present scope of interest of European Union – the housing market. Simultaneously within the framework of NPD it is expected to outline the long-term strategy of housing market development for a period of 2005-2025.

The primary aim accepted in the long-term strategy of housing development is the improvement of the level of satisfied housing needs in Poland as to reflect the current level of satisfied housing needs in European Union Countries. Achievement of this aim will be finalized at separate stages, which do not correspond only with the period covered by NDP 2007-2013.

APPENDIX 1

Individuals

Table 1: Housing loan outstanding (in thousand PLN)

period	2003	2002	2003/2002
January	17 560 572.36	10 551 120.31	66%
February	18 128 505.27	12 181 807.64	49%
March	19 107 591.48	12 403 426.78	54%
April	19 001 083.75	12 729 486.41	49%
May	19 602 724.96	13 565 574.23	45%
June	20 475 016.69	14 590 789.38	40%
July	20 994 343.69	15 373 261.37	37%
August	21 629 612.90	15 743 907.38	37%
September	23 176 478.38	16 183 871.84	43%
October	24 110 244.97	16 193 110.89	49%
November	24 884 215.19	16 408 329.10	52%
December	25 492 926.34	17 038 629.16	50%

Source: Polish Bank Association. Data cover 85% of the housing loan market.

Table 2: Housing loan granted – the average amount (in thousand PLN)

period	2003	2002	2003/2002
January	82.81	69.62	19%
February	84.01	72.52	16%
March	83.06	68.01	22%
April	79.15	72.57	9%
May	82.25	72.68	13%
June	81.34	76.22	7%
July	82.77	73.09	13%
August	82.40	72.34	14%
September	82.58	74.04	12%
October	81.37	71.81	13%
November	85.98	73.94	16%
December	85.89	82.53	4%

Source: Polish Bank Association. Data cover 85% of the housing loan market.

Table 3: Total amount of housing loan grated (in thousand PLN)

period	2003	2002	2003/2002
January	469 798.90	435 886.88	8%
February	559 336.17	457 747.21	22%
March	768 509.56	556 751.07	38%
April	788 496.12	658 952.77	20%
May	823 606.00	671 535.57	23%
June	863 328.80	791 289.00	9%
July	1 022 569.59	748 701.53	37%
August	900 143.76	644 540.36	40%
September	1 031 837.12	665 780.31	55%
October	1 172 401.78	665 524.53	76%
November	1 051 416.33	553 831.89	90%
December	1 150 275.58	605 119.72	90%

Source: Polish Bank Association. Data cover 85% of the housing loan market.

Table 4: The number of housing loan granted

period	2003	2002	2003/2002
January	5 673	6 261	-9%
February	6 658	6 312	5%
March	9 253	8 186	13%
April	9 962	9 080	10%
May	10 014	9 239	8%
June	10 614	10 381	2%
July	12 355	10 244	21%
August	10 924	8 910	23%
September	12 495	8 992	39%
October	14 409	9 268	55%
November	12 228	7 490	63%
December	13 392	7 332	83%

Source: Polish Bank Association. Data cover 85% of the housing loan market.

Corporations

Table 5: Housing loan outstanding (in thousand PLN)

period	2003	2002	2003/2002
January	3 705 098.50	2 629 746.87	41%
February	3 778 761.92	2 757 124.68	37%
March	3 820 886.58	2 679 653.39	43%
April	4 093 765.90	2 694 986.37	52%
May	3 904 810.59	2 928 913.00	33%
June	3 964 913.26	3 206 446.23	24%
July	4 032 549.29	3 270 941.31	23%
August	4 063 452.86	3 367 557.16	21%
September	4 114 902.04	3 470 470.58	19%
October	4 199 134.05	3 533 175.69	19%
November	4 247 382.35	3 569 764.64	19%
December	4 270 746.11	3 652 684.22	17%

Source: Polish Bank Association. Data cover 50% of the housing loan market.

Table 6: Total amount of housing loan grated (in thousand PLN)

period	2003	2002	2003/2002
January	66 767.60	18 849.30	254%
February	52 755.30	17 698.58	198%
March	40 370.04	22 247.36	81%
April	92 541.00	27 608.95	235%
May	44 129.65	61 691.35	-28%
June	97 046.37	120 888.00	-20%
July	150 683.73	170 124.93	-11%
August	90 643.39	123 351.40	-27%
September	124 911.38	180 656.22	-31%
October	115 434.59	91 590.45	26%
November	122 632.00	81 337.00	51%
December	347 580.78	141 143.50	146%

Source: Polish Bank Association. Data cover 50% of the housing loan market.

Table 7: The number of housing loan granted

period	2003	2002	2003/2002
January	20	7	65%
February	22	10	55%
March	19	10	47%
April	23	11	52%
May	19	22	-16%
June	47	32	32%
July	35	45	-29%
August	32	37	-16%
September	46	49	-7%
October	43	33	23%
November	33	18	45%
December	70	34	51%

Source: Polish Bank Association. Data cover 50% of the housing loan market.

APPENDIX 2

Table 1: Mortgage bonds issuances (total)

	2000	2001	2002	2003	*TOTAL*
Value of issuance (in million EUR)	4.75	21.50	29.54	122.40	178.19

Source: Mortgage Credit Federation

Table 2: Non-public issuances of mortgage bonds by major mortgage bank

Date of issuance	Date of maturity	Currency	Value	Rating Fitch/Moody's
28.06.2000	28.06.2005	PLN	5,000,000	BBB+ / A2
29.07.2002	31.07.2006	PLN	50,000,000	BBB+ / A2
20.05.2002	20.05.2009	EUR	10,000,000	BBB+ / A2
20.05.2003	20.05.2009	EUR	20,000,000	BBB+ / A2
20.05.2004	20.05.2009	EUR	25,000,000	BBB+ / A2
20.11.2001	21.11.2005	USD	10,000,000	BBB+ / A2
20.05.2002	20.05.2008	USD	10,000,000	BBB+ / A2
20.05.2004	20.05.2009	USD	25,000,000	BBB+ / A2

Source: Internet

Table 3: Public issuances of mortgage bonds by major mortgage bank

Date of issuance	Date of maturity	Currency	Value	Interest	Rating Fitch/Moody's
10.04.2003	10.04.2008	PLN	200,000,000	WIBOR 6M+0,60%	BBB+ / A2
23.10.2003	10.10.2008	PLN	200,000,000	WIBOR 6M+0,49%	BBB+ / A2

Source: Internet

Table 4: Mortgage bonds issuances by second major mortgage bank

Date of issuance	Maturity	Currency	Value	Profitability
December 2000	10 years	EUR	3,630,000	5.95% - fixed
April 2003	5 years	PLN	22,000,000	WIBOR 3M+0,60%
May 2003	5 years	PLN	18,000,000	WIBOR 3M +0,50/0,60%

Source: Internet

ADDITIONAL INFORMATION

Taxation Relief

The present forms of the state support in the sphere of housing (basic information)

1. Taxpayer's right to deduct interest paid on a housing loan from taxable income – personal income tax only

To be eligible for tax deduction a taxpayer must comply with several conditions:

1) Housing loan or housing credit must be contracted following 1st January 2002.[6] Previously the taxpayer (or taxpayer's spouse) must not have used taxation relieve for housing purposes including contract saving system[7];

2) Interest on housing loan or housing credit contracted in commercial bank or in co-operative savings and credit union system (SKOK) must be intended for satisfying taxpayer's housing purposes. Credit or loan resources must be directed for one of the below mentioned purposes:

   - Construction of residential building; tax relieve does not apply to the interest on credit or loan for acquisition of a parcel or perpetual usufruct,

   - Providing a construction or housing contribution to co-operative[8] in order to acquire the right to newly-constructed residential building or a dwelling in such a building,

   - Acquisition of newly-constructed residential building or a dwelling in such a building from municipality or developer,

   - Reconstruction or alteration of a unit or a building or a part of a building previously utilized as a non-for-housing into a residential one (such converted dwelling must comply with regulations stipulated in the Building Law).

First deductions are possible to make when all expenses related to the investment project are known which in fact means in the fiscal year when the investment is completed.

Annual taxable revenues are decreased by the amount of actually incurred interest expenses on housing loan or housing credit. The accumulated amount of interest which was paid in the period since 2002 till the year of investment completion is a subject of deduction in the first year of execution the taxation right or in the following year. The latter implies that deducted is only the difference between the sum of interest to be deducted and the amount of interest actually deducted in the prior year (the year of first deduction).

Deductions of interest are limited on credits or loans the amount of which does not exceed the product of 70 square meters of a dwelling and a value of a square meter of usable floor which is set in order to determine the guaranteed bonuses for owners of saving-for-housing booklets. The basis for determination of such a limit is a value of a square meter set for third quarter of fiscal year in which an investment was completed[9].

Last not least there are no time-restrictions of execution the right to the tax relieve. In fact it means that the taxpayer is in a position to deduct interest actually paid in a given fiscal year on condition that the deductions does not exceed the amount of interest on limited credit (described above).

2. Taxpayer's right to deduct part of the expenditures for renovation and modernisation of dwellings and single-family houses from tax due

Taxpayer is in a position to decrease a tax due when incurred expenses for modernization and renovation of residential building or a residential unit the legal title of which belong to him/her. Also the payments to renovation fund of condominium or co-operative are subjects of deductions.

Since 1997 all source of expenditures for modernization and renovation of residential building or residential unit are itemized in the ordinance on specification of expenditures for modernization and alteration of residential buildings and residential units by the amount of which a taxation due is reduced. Annexes to the ordinance enumerate the following expenditures:

1) Acquisition of materials as well as appliances,

2) Acquisition of services (expertise, opinion, delivery of materials and appliances etc.),

3) Lease of construction equipment,

4) Administrative expenses and others.

To execute the right to taxation relieve the taxpayer must posses a legal title to a unit or to a building. These are as follows:

1) Proprietary right,

2) Co-operative right under ownership,

3) Co-operative right under tenancy,

4) Municipal tenancy right,

5) Tenancy agreement,

6) Sub-tenancy agreement,

7) Leasehold agreement,

8) Agreement of life-span utilization.

The expenditures must be invoiced and certified by a VAT taxpayer who does not utilize the right to exemptions or SAD evidenced in case of imported materials. Exempted are payments to renovation fund (in this case expenditures are confirmed by the evidence of payment).

The expenditures are subject to deductions only if:

1) Relate to units/buildings which are situated in Poland,

2) Not classified as cost of obtaining income,

3) Not distributed back to the taxpayer in another form.

The limit of deductions of expenditures is prolonged for three consecutive years. The maximum amount of expenditures to be deducted in each of three-year period depends upon the renovation of either a dwelling or a house. In each case the tax due is reduced by 19% of incurred expenses yet no more than:

1) 2.5% of the amount equal the product of 70 square meters of a dwelling and a value of a square meter of usable floor which is set in order to determine the guaranteed bonuses for owners of saving-for-housing booklets. The basis is for the first year of a three-year period – if expenses relate to residential unit (dwelling);

2) 3% of the same amount – if expenses relate to residential buildings or payments to renovation fund in condominium or co-operative.

The tax relieve is to operate up to the end of 2005.

3. Preferential rates of value added tax for selling dwellings as well as for construction services

According to the Accession Treaty and new bill on Value Added Tax, until the end of 2007 all of the housing sector will take advantage of reduced VAT rate (7%) on supply, construction, renovation and alteration of housing. With the date of Polish accession to UE, however, VAT rate for construction materials was established at the level of 22% (previously at 7%). After 31st December 2007 the reduced VAT rate will only be allowed with respect to housing provided as part of a social policy.

NOTES

1 Another factor which significantly contributed to reported growth was gross capital formation.

2 Excluding dwellings which are subject to demolition with unknown purpose or desolated/abandoned

3 Intervals covered by census data

4 Since 1st January 2005

5 The contract saving system (kasy mieszkaniowe – KM) institutions which started operations in late 1996 and in 1997, have granted insignificant numbers of loans to date. At present the system of KM tends to a gradual decline. Recent changes in tax relieves made saving for housing purposes less beneficial to users (since January 2002 the tax incentive was abandoned). The average amount of deposited financial means in one account in contract saving system as at the end of 2001 reached 20,340 zlotys. The total number of contract saving system accounts as at the end of 2001 reached approximately 63,700, of which initiated in 2001 – 19,840.

6 Until 2002 a different kind of personal income tax relieve was operated. A tax-payer had a right to deduct part of the cost of construction or acquisition of residential building/dwelling from his/her tax. That system was very poorly targeted as the tax-payers with high income who had purchased expensive residential buildings received as much or usually more support than the less affluent, who did not purchase dwellings expensive enough to use up all the limit (19% of the average price of construction of a 70 sq. meter of residential unit).

7 Until 2001 there were two different contract savings systems established by separate legal acts. First one is the Act of October 1995, which introduced the institution of *kasa mieszkaniowa* (KM). The other was the Act of June 1997, which regulates the operation of *kasa oszczednosciowo-budowlana* (KOB), modelled on contract savings systems existing in Germany and Austria (*bausparkassen*). The KOB system did not come in operation, due to the government's initiative (supported by the central bank) to stop the licensing process until the Law of 1997 is amended. In 2001 the system of kasa oszczednościowo-budowlana was abolished.

8 Co-operative members awaiting for establishment a co-operative tenancy or co-operative ownership right to the residential unit or a proprietary residential unit right are obliged to participate in the construction expenditures by the way of providing a construction or housing contribution or covering other liabilities related to construction works which stem from the resolutions of the co-operative statute.

9 Third quarter value of a square meter in 2003 was 2,117 PLN (the € exchange rate as at 30th September was 4.6435 PLN)

CHAPTER 2. HOUSING FINANCE IN HUNGARY

by

András Bethlendi and Gergely Kiss*

1. Macroeconomic Overview

The Hungarian policymakers are fully aware of the net gains that the single currency can bring to the Hungarian economy, and therefore support the adoption of the euro. At present, the government, based on the convergence program submitted in December 2004, considers 2010 as a feasible target date for euro adoption.

During the last years, however, Hungary has somewhat drifted away from the fulfilment of the Maastricht criteria. In terms of inflation, the hike in the indirect tax rates in early 2004 resulted in yearly average inflation above the previous years, though significant disinflation started later in the year. Long bond yields rose significantly in 2003, followed by a gradual decline in the second half of 2004. The ESA 95 deficit of the general government reached 5.3 per cent in 2004, an improvement compared to 2003, still government debt increased to 60 per cent of GDP in 2004.

GDP growth accelerated to 4% in 2004, together with the improvement of its structure. Positive developments in the external business environment have contributed to the pick-up in Hungarian exports, which, in turn, has led to a robust rise in output and an upturn in corporate investment activity. These developments and a slowdown in household consumption influenced the pattern of growth favourably: the export sector and fixed investment are the driving forces of growth, replacing domestic consumption, and leading finally to an improving external balance.

Household consumption growth in 2003 was above 7 per cent as a result of high real wage increases in the private sector and the relaxed fiscal stance. Both household consumption and real wage growth decelerated significantly in 2004, returning to a sustainable path after the shocks of the previous years. The easing of the labour market tightness also contributed to the marked slowdown of nominal wage growth registered in the second half of 2004.

Household investments also showed a remarkable increase due to a subsidised housing loan scheme (see next chapter for more details). Business investments, following external demand, were weak until mid-2003, but have accelerated markedly since then. There was a particularly strong pick-up in manufacturing investments in the second half of 2003, and it remained buoyant in 2004.

The current account deficit is expected to reach 8.9 per cent of GDP in 2004, showing only a slight improvement from the previous year. As a result, the whole-economy external financing requirement remained high. The major causes behind this development are the substantial rise in the external financing requirement of the corporate sector due to brisk investment activity and the still high external financing requirement of the government sector. The household sector which had the lowest net saving in 2003 for a decade, improved its position during 2004. The financing of the current

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account deficit also showed an improvement last year, FDI inflows financed nearly half of the deficit in the first three quarters. In light of the still existing vulnerabilities the sustainability of external balances is primarily dependent on the future development in the government sector financing requirement and, therefore, on the credibility of fiscal consolidation targets.

After declining to below 4 per cent by mid-2003, inflation started to pick up in the second half of the year, reaching 5.7 per cent by December 2003. The rise was discernible in core inflation, as well as among goods exogenous to monetary policy (e.g. food prices) and administrative measures. Accelerating core inflation was fuelled by nearly all macroeconomic factors both on the demand and the cost sides. Particularly unfavourable was the rise in non-tradables inflation, suggesting a pick-up in inflation expectations. The main reason for the CPI rise in 2004 was indirect tax increases, although demand and supply factors also contributed to the increase in inflation in the first half of the year. Disinflation gained momentum in the second half of 2004. The rapid decline in inflation from its 7,6 per cent peak was partly associated with a fall in firms' and households' inflation expectations. On balance, it seems that the increase in indirect taxes did not have a lasting upward influence on inflation expectations.

Table 1. Key macroeconomic indicators

	Relative to previous year (%)			
Economic indicator	2001	2002	2003	2004
GDP	3.8	3.5	2.9	4.0
Household consumption	5.1	9.3	7.6	3.2
Gross fixed capital formation	3.1	8.0	3.4	11.6
Export	9.1	3.7	7.6	14.1
Import	6.3	6.2	10.4	14.8
Consumer prices	9.2	5.3	4.7	6.8
Real household income	5.3	5.5	4.3	3.4
General government deficit (ESA 95 methodology) *	4.1	9.3	6.2	5.3
Current account deficit*	6.0	7.1	9.0	8.9**

* As a percentage of GDP ** Estimate (Inflation Report 2005 February) Source: MNB

2. Evolution of the Hungarian Mortgage Market

At the beginning of the transition in the early 1990s, there was no mortgage market to speak of in Hungary. Although there was a considerable amount of subsidised housing loans during the socialist regime, the government decided to abolish the subsidy on account of the rising budget deficit, which attended the collapse of the centrally planned economy. Following the legal disputes over the termination of the subsidy for existing, long-maturity loans, the subsidised housing loans were converted into market-rate loans, significantly increasing the debt servicing obligations of households. However, debtors were given the option to repay the debt with a highly advantageous discount. Since many households chose the prepayment option, the outstanding amount of housing loans decreased to less than HUF 150 bn by 1991, equivalent to 6 per cent of GDP. It decreased further in nominal terms, becoming insignificant, from a macroeconomic point of view, for almost a decade.

There were basically no new housing loans during the years when inflation was high and volatile. In 1991, the inflation rate peaked at 35 per cent, remaining above 15 per cent until 1998. In light of this, and considering the 1/3 prudential limit on debt service/disposable income, households could thus not raise loans exceeding their 2-year-income[1], even with nominal interest rates close to 15%. High and volatile rates of inflation in the first half of the '90s also led to the shortening of business contracts.

Economic agents did not want to get tied down to long nominal contracts. This was particularly true in the financial markets. Even the Hungarian government could not issue long-term forint bonds; the 5-year government bond appeared in the market only in 1996. Considering that mortgage loans cannot have maturities longer than benchmark government bonds, the short yield curve also significantly constrained the potential growth of the mortgage market. In short, a confluence of factors hampered the growth of the mortgage market in the first years of the transition: high and volatile inflation, as well as low household demand for mortgages owing to declining real wages and rising unemployment.

Economic consolidation began in the mid '90s. This was accompanied by increasing credibility in the stability oriented economic policy. As a result, long yields and the inflation rate declined continuously from 1997, parallel with the gradual extension of the benchmark government yield curve to longer maturities of 10 and 15 years in 1999 and 2001, respectively. These developments created the requisite financial environment for the full functioning of a mortgage market in Hungary.

Chart 1: Evolution of the 5Y benchmark rate and inflation

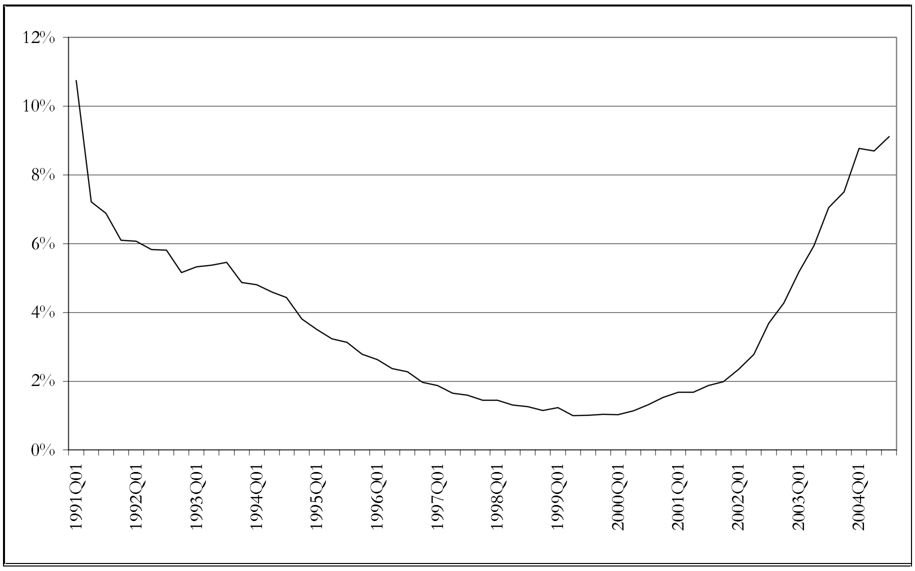
Source: MNB

Alongside these developments was the establishment of the legal framework for the Hungarian mortgage market. In 1997, the Parliament passed the Act on Mortgage Institutions. In line with this, new regulations in related areas, such as loan origination, foreclosure and prudential limits, were harmonized with the EU legal framework. However, despite improving macroeconomic and financial conditions and the institution of a legal and regulatory framework, the mortgage market remained stagnant until 2000 when the government introduced mortgage-related subsidies.

In 2000, more than 10 years after the loan subsidies were abandoned in the last years of the socialist regime, the government introduced interest subsidies to long mortgage loans for new housing constructions. The main rationale for instituting the new housing policy measures was the fact that the number of new housing constructions had been declining throughout the '90s. This decline was, to a large extent, due to the lack of house financing: households could rely only on their savings to finance housing investment.

These early measures promoting only new housing constructions did not have a major macroeconomic impact. However, they did give impetus to the previously inert mortgage market. In 2000, the households' mortgage/GDP ratio started to post some growth. To further foster this growth, although to a smaller extent, the government extended the subsidy to buying existing dwellings as well. Meanwhile, macroeconomic conditions had also become favourable: the inflation rate dropped below the 7 per cent target at end-2001, while the yield curve showed a steep negative slope, reflecting investors' confidence in the profitability of the convergence play strategy in the Hungarian government bond market. The new government measures, along with the favourable macroeconomic conditions, resulted in a gradual increase in mortgage loans, with an average of HUF 15 bn of new loans granted in 2001. However, the outstanding stock by the end of the year still did not exceed 2% of GDP.

Chart 2. Mortgage/GDP in Hungary



Source: MNB

The year 2002 brought dramatic changes to the mortgage market. Government subsidies directly targeting households were increased significantly at the beginning of the year. Moreover, through subsidies linked to funding costs, bank margins climbed to 8 per cent. Meanwhile, the subsidy scheme was exhibiting a rather unusual feature: the interest burden of households was not sensitive to market rates; all interest rate risk was with the central budget. The most general mortgage type was a 15-20 year loan, with the interest rate fixed for 5 years, and a cap on interest paid by households at 6 per cent for existing dwellings and even lower for new constructions. These rates were even significantly lower than benchmark government yields at that time.

This subsidy scheme was clearly not going to be sustainable. Under this scheme, even households, which would otherwise not have considered taking on a mortgage loan in the near future, were applying for loans simply to take advantage of the favourable conditions. This resulted in such a sudden and significant rise in mortgage loans that, by the middle of 2002, the mortgage market had started to post exponential growth. In the second half of the year, the volume of new loans originated in 2 months exceeded the total volume originated in the previous year. However, the government was slow to respond. It decided to cut the subsidies substantially only in December 2003, amidst serious concerns of the external and internal stability of the Hungarian economy.

During the heavily subsidised period households had the incentive to borrow more than what they needed for housing purposes. The main reason for this was the combination of the previously binding liquidity constraint on households and the generous subsidies made available for existing dwellings.

The existence of the 'borrow more effect' involving housing transactions can be illustrated with an example. Households who would like to purchase a more expensive apartment sell their old one and take out a mortgage loan with the highly advantageous interest rates. On the aggregate level, if the transaction involves only existing dwellings, there is no change in the net financial position of the household sector, as the mortgage loan equals the increase in the savings of the seller. However, due to the low interest rate, the household taking up the mortgage might consider taking out a bigger loan to finance consumption, for instance, to furnish the new apartment. If LTV and debt service/income ratios are at manageable levels, households could significantly ease the liquidity constraint. Calculations (MNB 2004) showed that 15-30 per cent of mortgage loans raised for existing housing could have financed consumption during 2001-2003. The estimation was based on the unexplained consumption growth by standard factors such as income, financial and housing wealth, and the consumer confidence index.

The tightening measures in December 2003 primarily attempted to cut the budget expenditures on interest rate subsidies. Given the lower subsidies for the new loans, the profit margin of the banks decreased parallel with the significant increase in the interest burden of the households. Furthermore, the changes to the subsidy scheme brought two new features: mortgage rates became partly linked to market rates, and the difference between subsidies for new and existing housing widened from 1 to around 3 percentage points.

From the monetary policy point of view, the most relevant impact of the tightening measures was the establishment of the link between the mortgage rate faced by households and the market rate. The reason why tightening measures had immediately a great impact on the demand for new loans may be attributed not only to the fact that subsidies were significantly cut but also to the unfavourable market developments. As concerns about the external and internal equilibrium of the Hungarian economy increased in 2003, the long segment of the yield curve started to increase significantly, putting an end to the yield convergence that characterised long yields in the previous years.

As a natural consequence of the tightening measures and the high long rates, loan origination dropped significantly in 2004. At the same time, new products appeared in the market: foreign exchange-denominated mortgages. Faced with the high forint mortgage rate, a growing number of households opted for mortgages with a lower nominal rate, notwithstanding the imminent exchange rate risk.

The following table summarises the direct macroeconomic effect of interest expenditure through disposable income, based on the evolution of the mortgage market and the government subsidy scheme discussed above.

Table 2. Disposable income and mortgage interest payments

Year	Households' disposable income (bn HUF)	Mortgage interest expenditure (bn HUF)	Interest/Disposable income (%)
2001	8913	18.4	0.21%
2002	9742	53.4	0.55%
2003	10863	95.4	0.88%
2004*	11950	132.2	1.11%

* Forecast *Source: own calculations*

The monetary transmission channel through interest payments of mortgage loans is rather limited in Hungary; mortgage loans have a weak direct impact on households' disposable income. There are a number of reasons explaining the situation. Despite the dynamic growth of the past years, the outstanding stock of mortgage loans is still low compared to those in developed countries. The central bank interest rate affecting the yield curve has only a minor impact on the interest burden of mortgage loans due to the features of the government subsidies which were effective until 2003. Apart from the government subsidies, the fixed rate mortgages dominating the Hungarian market resulted in a delayed effect of interest rate changes, similar to many eurozone countries.

In light of the rapid evolution of the Hungarian mortgage market in recent years, it is worth making a brief comparison with the structures prevailing in other OECD countries. The developed countries can be divided into three types of mortgage regimes, namely fixed callable, fixed non-callable and variable. The following table, grouping the countries according to mortgage regimes, summarises the major characteristics of the housing and mortgage markets in mainly EU countries, including Hungary.

Table 3. Key mortgage and housing indicators in developed countries (2001) and Hungary (2003)

Countries	Dominant type of mortgage	Mortgage/GDP	Average LTV	Owner occupation
Denmark	Fixed callable	67%	80%	59%
US		58%	78%	68%
Germany	Fixed non-callable	47%	70%	39%
Netherlands		74%	112%	53%
France		22%	60%	58%
Italy		10%	55%	69%
Hungary		**8%**	**30-40%**	**92%**
UK	Variable	60%	70%	68%
Ireland		30%	60-70%	78%
Portugal		47%	70-80%	64%
Spain		32%	80%	85%

Source: ECB, MNB

The first observation that can be drawn from the table is that, despite their similarities in recent macroeconomic framework (low inflation, co-ordinated and stability-oriented economic policy), sound and liberalised financial systems, and a high standard of living, developed countries exhibit a surprisingly wide range of key indicators.

Highly efficient and mature financial markets should be able to provide mortgage loans that have fixed interest rates for up to 10-15 years and should have the flexibility that is needed for the early repayment of long mortgage loans. Both the US and Denmark have above-average owner-occupation rates, as well as a very high mortgage/GDP ratio, indicating the significant role of mortgages in the economy.

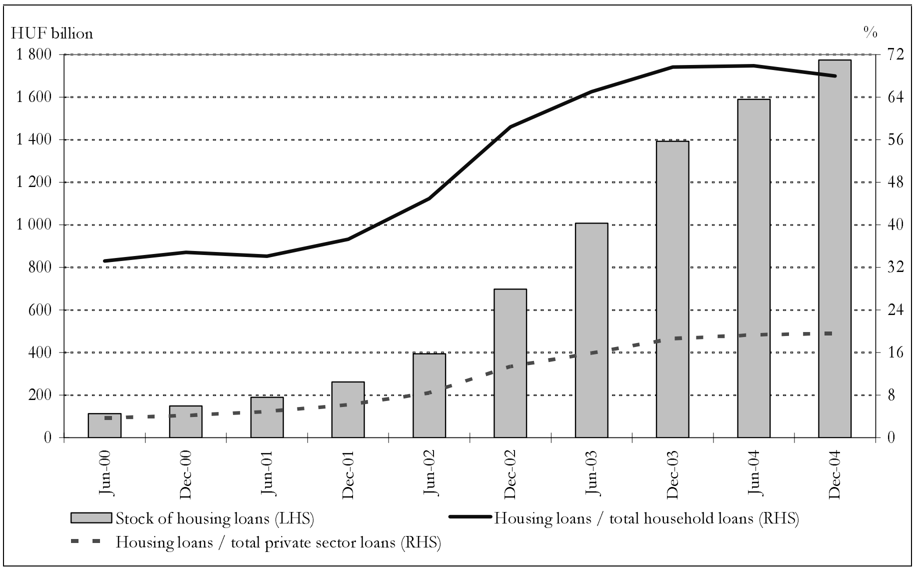
The second group consists of countries where the majority of mortgage loans have fixed interest rates, but early repayment is constrained by high fees. Most of the continental European countries belong to this category. In some of these countries mortgage loans do not play a very significant role in the economy: the ratio has been traditionally low in France and Italy, at 22 per cent and 10 per cent of the GDP, respectively. Hungary also belongs to this group and the mortgage indebtedness of the Hungarian households is already close to the level of Italian households. It has to be noted, however, that due to the rapid increase in the dominantly variable rate FX mortgages, the Hungarian market is also moving towards variable rate dominated regimes.

The mortgage markets in the third set of countries are characterised by variable interest rates. Apart from the UK, the fast growing mortgage markets of Portugal and Spain are also dominated by variable rates. These eurozone members benefit from low interest rates, considering that, prior to the nominal convergence, high interest rates generated liquidity constraints for the majority of the households. In Portugal, the mortgage debt/GDP ratio was 47 per cent in 2001, equal to that of Germany, while a decade earlier, it was comparable to that of Italy. This rapid growth is, to a great extent, similar to the Hungarian dynamics in recent years.

3. Structure of Loans Providers

Banks are predominant players in the domestic housing loan market. They provide more than 90% of loans. Commercial banks with a large number of branches have been the real winners of the housing subsidy scheme. The degree of concentration is high; the Herfindhal-Hirchman index was around 3100 in December 2004.[2] 68% of loans to households are for housing purposes, approximating the EMU level (the average ratio of housing loans to other household loans is two-thirds to one third). The share of housing loans in total banking assets is 12%, approaching the 15% rate of the euro area.

Chart 3 Banks' housing loans and their share in household and private sector loans



Source: MNB

Next players of the housing finance market are *savings co-operatives*, which have suffered a significant loss of market share. Their market share in the aggregated volume of loans collateralised with housing real estate fell sharply from 19% in 2001 to 7% in 2004. The major underlying reason for this loss of market share was that savings co-operatives have been unable to directly participate in the subsidised housing loan scheme, as savings co-operatives are not included amongst the counterparties of mortgage banks, and can only achieve a syndicated loan agreement with mortgage banks. In 2004 foreign currency based housing loans have become the most developing segment, which co-operatives are also unable to offer, since the scope of their activity is limited and does not include the provision of FX or foreign currency based loans.

The state housing subsidy system relatively disadvantages *contract savings institutions*, which will keep to a niche market segment in the future, too. At present only two closed contract savings institutions are working, there aggregate market share is around 1%.[3] The state provides subsidy through tax allowances, but its maximum amount is limited. Following the restrictions of subsidised housing loans, the market position of contract savings institutions has ameliorated somewhat. However, the optimal loan is a strong constraint on their growth, because it is very low compared to the price of an average home is still.

Finally, *insurance companies* should be mentioned. They are entitled to engage in mortgage financing,[4] but actually they do not provide mortgage loans on their own, and only two insurance companies act as a syndicated partner of a mortgage bank. However, their long-term cheap funds should be used for mortgage financing.

4. Liabilities Side, Financing Techniques in Hungary

Dynamic growth in assets has been accompanied by a similarly vigorous growth in liabilities. Mortgage lending, in keeping with international practice, relies mainly on such techniques of incurrence of liabilities that are different from those of traditional lending. Statutory and regulatory stipulations have also been instrumental in the development of the necessary structures. Under Hungarian law, mortgage bonds may only be issued by mortgage banks. Housing subsidy was mainly linked with mortgage bonds. Therefore credit institutions having enough other liabilities also used mortgage banks' refinancing to qualify for the government subsidy.

4.1. Refinancing Techniques of Mortgage Loans

In terms of the financing techniques adopted, the practice and procedure of mortgage lending varies from one country to another, and may be different even within one country. In the EU Member States there are two ways to finance mortgage loans through mortgage bonds:

- *Direct financing (the one-tier model)*: banks originating mortgage loans group loans themselves and issue mortgage bonds to incur liabilities. This is a widespread practice, e.g. in Germany and Denmark.

- *Indirect financing (the two-tier model)*: banks originating mortgage loans sell their loans to a third company; the latter then puts them into a 'pool' making mortgage backed security (MBS). This is widespread practice mainly in Anglo-Saxon countries.

Both of the above mentioned models are used in Hungary. One is the purchase of independent lien, a special form of indirect finance. Another is loan originated by mortgage banks on their own, which corresponds to the concept of the one-tier model. Mortgage banks play a pivotal role in both techniques and determine the structure of the housing loan market. Currently, there are three mortgage banks operating in the Hungarian banking system. No new market participants are expected to emerge even over the longer term.

4.1.1. Refinancing based on the purchase of independent lien

The underlying idea of this refinancing facility is that mortgage banks that issue mortgage bonds refinance commercial banks originating mortgage loans under independent lien (mortgage right) sales contracts. Banks repurchase independent lien at the pace loans are repaid. Mortgage bonds are collateralised through the refinancing of loans with independent lien. As mortgage loans continue to be recorded on the balance sheet of the originator credit institutions, both credit and prepayment risks are borne by the bank that originates the loan and, indirectly, by the mortgage bank involved. Mortgage bonds investors only take low risks, since mortgage loans are repaid to the mortgage bank if the partner bank goes bankrupt. The prepayment of the client to the commercial bank might not be refused. At the same time in order to protect the interest of the mortgage bond investors the mortgage bank might stipulate in contract the refusal of the prepayment, or, calculating fees which may limit the prepayment. The commercial bank might roll over this fee to the client. Földhitel és Jelzálogbank (FHB), still partially in state ownership, has entered into a refinancing agreement with eight commercial banks. HVB Jelzálogbank, 100%-owned by its parent bank (HVB), has entered into a refinancing agreement with four commercial banks.

4.1.2. Mortgage Banks' Loans Provision

Mortgage banks finance the loans sold via their own distribution network or agents by issuing mortgage bonds. Both loans and mortgage bonds are recorded on the balance sheet of mortgage banks. Under syndicated loan agreements, credit institutions and mortgage banks form a syndicate and, as such, they distribute loans via their distribution network. When a loan is originated, a mortgage bank purchases it, so it is no longer recorded in the balance sheet of the relevant credit institution. As a result, lending risks are taken by mortgage banks. Mortgage banks issue mortgage bonds collateralised with the mortgage loans purchased.

The market leader, OTP Jelzálogbank, which is 100%-owned by its parent bank (OTP), only originates housing loans under a syndicate agreement with its parent bank. FHB originates housing loans through agents and via its own distribution network, and has entered into a syndicate agreement with sixty-five co-operative banks.

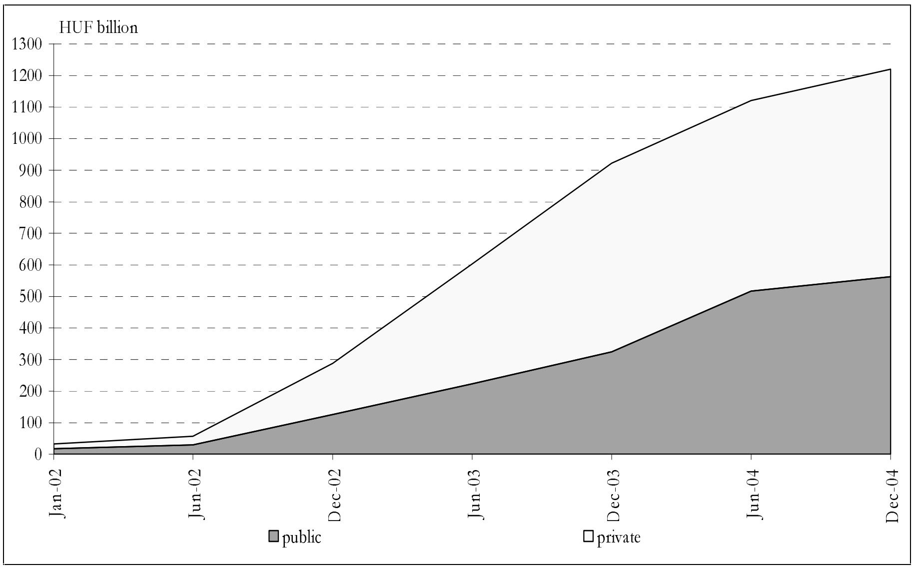
4.2. Financing based Loans

The market share of mortgage-based loans is still low due to the boom of subsidised housing loans. Given the lower housing subsidies in 2004 foreign currency denominated products has started to growth sharply. Mortgage-based loans are mostly financed by traditional liabilities, which are mostly short term client and foreign bank deposits. The share of bonds within commercial banks' liabilities is for the time being minimal (1-2%). Therefore an increase in maturity transformation carried out by commercial banks has accelerated in recent years.

5. Mortgage Bond Market

Since 2002, in parallel with the boom of housing loans, the mortgage bond market has become *the most developing segment* of the Hungarian securities market. In December 2004, the total value of the mortgage bonds issued by the three mortgage banks was more then HUF 1220 billion (EUR 4.9 billion), half of this being sold through public offerings. (Chart 4) The biggest mortgage bank mostly used to choose private offering issuance subscribed by its parent bank. In this way the financial group saves on a spread of mortgage bonds. Because the parent bank had a lot of liquidity, it partially substituted its government bonds assets by mortgage bonds and retained the spread. The amounts of series are very low, the average series introduced to the stock exchange is around HUF 14 billion (EUR 56 million). There were successful issuances abroad, which amounted to EUR 100 million/issuance. Other important characteristics of mortgage bonds are similar to those of government bonds (ratings, interest rate and payments, etc.). Mortgage banks have proved flexible in their issuance (timing of issuance, amount and maturity of bonds), which can counterbalance the low liquidity of their securities.

Chart 4 Stock of mortgage bonds by the type of issuance



Note: two parent banks' subscription is considered as private issuance. *Source: MNB*

The main feature of the *secondary market* is the very low liquidity of mortgage instruments. The monthly turnover of government bonds is about 60% of total stock, while in the case of publicly issued mortgage bonds this rate is only 2%, and this turnover is mainly generated around the issuance day. The recently growing size of series has not affected the liquidity of bonds. The yield on mortgage bonds placed through public offering reveals a more advantageous picture than liquidity. The spread on mortgage bonds has decreased; recently it was 60-80 basis points higher than the benchmark government bond yield, which was not particularly high in an international comparison.

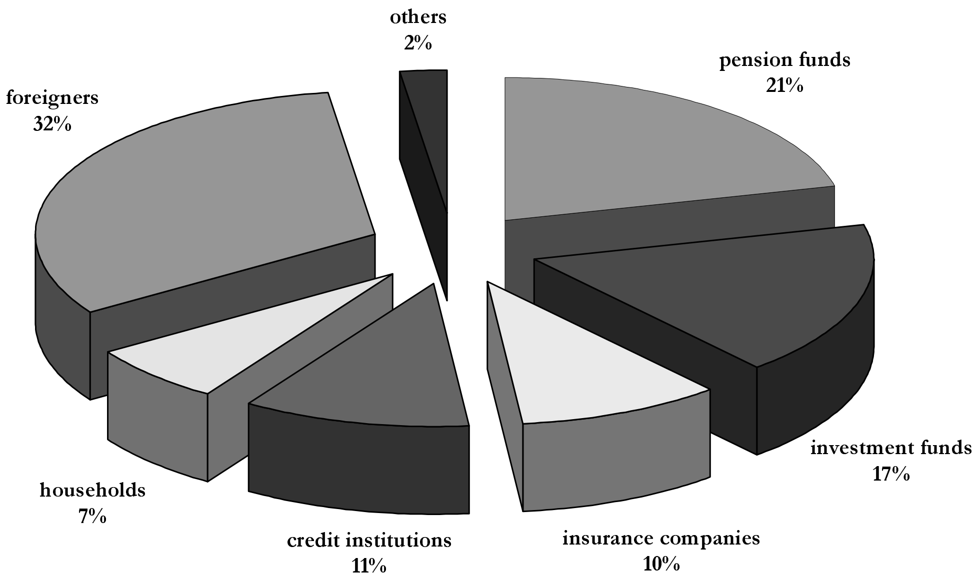
Domestic institutional investors (pension and investment funds, insurance companies) are the most important buyers of mortgage bonds; they hold nearly half of the total publicly issued bonds. (Chart 5) Owing to higher yields, this kind of investment is more attractive for them than government bonds. The future absorption capacity of domestic institutional investors is rather limited. Regulators imposed limits for institutional investors against similar types of investments or investments of the same issuer.[5] In 2004, this constraint may become effective for some institutional investors.

Credit institutions, because of the character of their activity, are also limited to buying longer term assets. They can buy mortgage bonds at government bonds' expense. With the exception of the two parent banks, banks hold little stock of mortgage bonds.

Households may purchase publicly issued mortgage bonds, but their share is lower (7%) compared to their share in the government bond market (14%). Mortgage banks and the parent banks are intending to boost households' bonds purchasing; therefore they are designing special products for them.

From the above it is clear that issuers of mortgage bonds rely on *foreign investors*, and their share is growing.

Chart 5 Privately issued mortgage bonds by type of investor



Note*:* private issuance = total private issuance – two parent banks' subscription *Source: MNB*

6. Special, Mainly Emerging Market Risk, Foreign Currency Based Lending

A growing share of foreign currency based housing lending can generate important additional risk in the emerging countries' banking sectors. As mentioned previously, at the end of 2003 the Hungarian Government tightened the conditions of the housing subsidy scheme. Consequently, the cost of subsidised borrowing for customers increased, with a simultaneous decline in the banking sector's gross margin. As an effect of the increase in Hungarian risk premium in 2003, the difference between Hungarian currency (forint) and foreign currency interest rates rose dramatically. Therefore, subsidised loans have become considerably more expensive for customers. These two factors have directed the attention of both borrowers and lenders to foreign currency based products.

In our assumption, also reinforced by banks' experience, a significant part of loan applicants make their borrowing decision based on the monthly cost of a loan, calculated on the basis of current interest and exchange rates. Typically, they choose the credit facility which has the lowest monthly instalment, without considering additional risks. In the near term, therefore, foreign currency based - crucially CHF - loans are crowding out a large part of forint-based loans owing to their lower cost. The share of foreign currency based loans within the total outstanding housing loans *sharply increased* from 1.4% in December 2003, to 7.5% in December 2004. However the volume of the foreign currency based portfolio amounted only to HUF 145 billion (EUR 0.6 billion). A decreasing difference between forint and foreign currency interest rates should ease up this tendency.

The *direct risks* of the sector emerging from the foreign currency based lending are relatively low. However the funding risk is growing owing to the increase in maturity transformation carried out by commercial banks. Currently, it is the borrower who bears the exchange rate and interest rate risks related to foreign currency based loans in full. In the case of non-performance of high LTV loans, causing the bank's foreign currency position to open up, the bank may no longer be fully protected.

The *indirect risks* of the sector are much higher. Instalment amounts on foreign currency denominated loans may change to a greater extent and more frequently than those on forint loans, owing to the short repricing period and the immediate passing on by the bank of the exchange rate risk to the borrower. Households are unprotected in the face of such changes, as the majority of them do not have natural cover. The extent to which risks undertaken by the sector are transformed into credit risk depends on the intensity and persistence of a given interest rate and/or exchange rate change. Obviously, the likelihood of delinquency increases if the debtor determines the maximum amount of loan based on the borrowing day's interest and exchange rates. Currently, short term interest rates are extremely depressed, moving at historical lows, in both the euro area and Switzerland. Based on the yield curve, short rates are likely to increase over the medium term. The forint exchange rate may undergo a period of depreciation. The likelihood of an increase in the instalment amount is not inconsiderable.

Bank margin and collateral requirements may offset the higher credit risk related to foreign currency loans. Currently, the average margin on foreign currency based bank products is approximately double the margin on subsidised forint loans, the former banks do not have to share with a mortgage bank. In spite of all this, we do not know whether pricing is proportionate with the additional risks undertaken, owing to a lack of experience. According to information currently available, most banks set a lower maximum LTV for their foreign currency based loans. If no negative shock occurs and the debtor defaults for some other reason, then a higher collateral value may result in a lower loss ratio and, through this, it may earn a higher profit for banks.

However the increasing popularity of foreign currency based lending makes the banking sector *more sensitive to external shocks*, which may lead to a wave of simultaneous defaults on a large number of loans. Owing to the relative homogeneity of collateral assets, banks may be faced with difficulties in selling collateral, which, in turn, may lead to a massive increase in the loss ratio.

Various *regulatory responses* are possible to reduce the additional risks related to foreign currency lending. APRC for housing loans has been introduced, in this way consumers can take account of the additional costs of foreign currency lending. To increase debtors' risk awareness, the Hungarian Financial Supervisory Authority is requiring banks to call every client's attention to the risks related to indebtedness in foreign currency in a special leaflet before the lending process gets underway.

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NOTES

1 Due to the effect of high interest rate on the liquidity constraint of a household, assuming a 20-year maturity and that 1/3 of disposable income is spent on the loan amortisation.

2 Parent banks are assessed together with mortgage banks.

3 In 1997-98 three were set up. One of them is owned by a domestic commercial bank, the other two were in majority foreign ownership (German, Austrian). They merged last year.

4 Since January 2001, but their mortgage loan volume is limited; it can be as high as 5% of their life insurance premium reserves.

5 The Hungarian regulation is based on international standards.

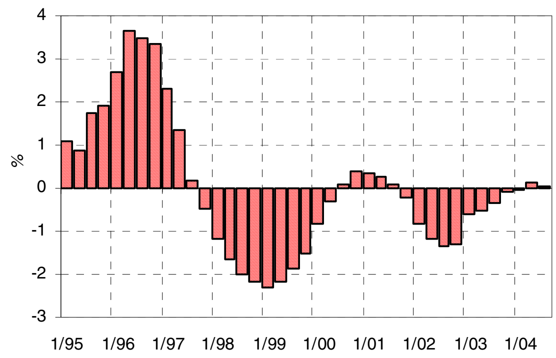
CHAPTER 3. HOUSING FINANCE IN CZECH REPUBLIC

by
Daniela Grabmüllerová*

1. Macroeconomic Characteristics[1]

Current Czech macroeconomic developments can be characterized as favourable. A rise in economic growth dynamics can be observed (to 4.1% in the second quarter of 2004 in year-on-year terms), driven by a higher investment activity and, recently, also by a leap in the economy's export performance. Growth acceleration is of both structural and cyclical character. Pace of potential product growth is increasing mainly thanks to robust growth of total factor productivity, closing, at the same time, a negative output gap. Since early 2004, year-on-year growth of consumer prices has been accelerating (to 3.5% in October 2004). It reflects impacts of administrative measures (especially harmonization in excise taxes and VAT), growth of food prices and increasing commodity prices on the world markets. Fall in employment still persists (by 0.8% in the second quarter of 2004 in year-on-year terms) and so dynamic economic growth is generated exclusively by rising labour productivity. Rate of seasonally adjusted registered unemployment peaked in March 2004, stagnating or slightly falling since then. External balance expressed by means of current account deficit to GDP ratio is worsening slightly (-6.4% at the end of the first half of 2004). It results from ongoing deepening of balance-of-income deficit; on the other hand, trade balance has been improving in spite of high oil prices.

Output Gap



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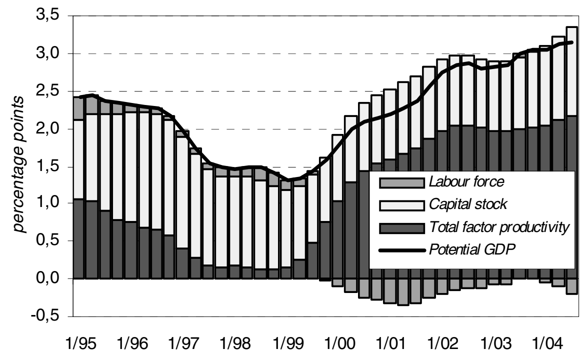
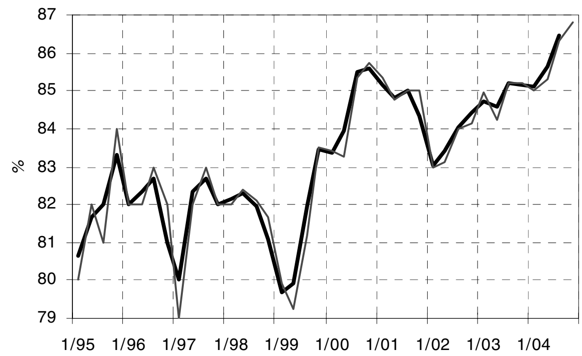
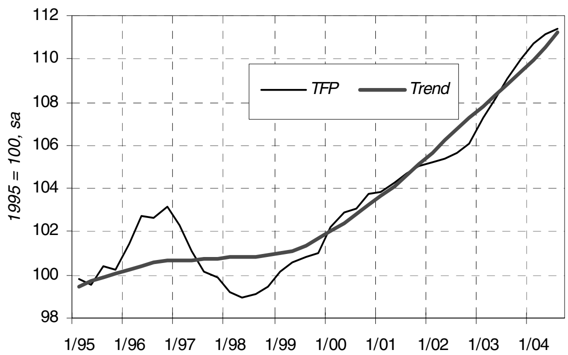
Potential Product Growth



Utilisation of Capacities in Industry



Total Factor Productivity



Negative output gap closed in the beginning of 2004 due to dynamic growth and the economy is now more or less at its potential level. In this stage of cycle, it is reasonable to boost the economy by policies oriented at increasing the growth of economic potential by means of steps on the supply side. A gradual acceleration of year-on-year growth of potential product from 2% in 2000 to some 3.1% in the third quarter of 2004 is a positive phenomenon. A robust growth trend of total factor productivity by some 2% a year is the main factor of this acceleration. It results from an improved functioning of the business sphere especially as regards the foreign-controlled businesses and financial system stability. On the other hand, there are still reserves in some parameters of institutional environment (such as poor enforceability of law or existing barriers to market entry/exit).

High dynamics of gross fixed capital formation contributes to an increase in the economy's capitalization as by means of improved infrastructure as through high-quality and competitive production units able to win recognition on the world markets. Functioning of the labour market can turn risk for acceleration of growth of potential product. Falling participation rate (share of labour force in the working age population) prevents the economy from making use of the still growing number of population in the age that allows them to be economically active.

Monetary policy of the Czech National Bank is conducted under inflation targeting regime. The target band for year-on-year increase of consumer price index (CPI) falls evenly from the level of 3 to 5 % in January 2002 to 2 to 4 % in December 2005. The CNB also announced inflation target for a period starting from January 2006 as a 3% year-on-year increase in CPI with maximum tolerance of +1 percentage point in either direction from this target. The target will apply until the Czech Republic joins the euro area. This CNB's stable monetary policy is an assumption for meeting the convergence inflation criterion and it creates a space for positive inflation differential against EU countries toward which the CZ economic level should converge, and corresponds to long-term expectations of financial markets. The forecast is based on an assumption of stability or moderate increasing of policy rates in 2005, followed with transmission in inter-bank and market rates. The CNB would be thus able to respond to domestic and Europe's recovery and to further assumed increases in Fed's rates and expected growth of ECB policy rates.

Deficit tendencies of the general government have been persisting in recent years. Their size cannot be explained by means of the current stage of the economic cycle. Deficits occur in spite of using one-off receipts, while growth dynamics of government debt accelerates. Structure of the expenditure side is encumbered with high share of social mandatory expenditures, which are not fully covered by revenues from social security and employment policy contributions. Besides the transformation-related costs, the general government bears the expenses related to improvement of infrastructure level and costs on convergence of policies, legal and institutional frameworks and environmental standards to those of the EU. Existence of structural deficiencies can be seen from development of public finance balance – general government deficits are not of cyclical character. Expenses are only partially allocated in areas that would generate positive multiplication effects in the long run. With regard to the above-mentioned negative development in public finances the political representation has come to an agreement on the need to reform them. Concept of the general government reform, produced by the Ministry of Finance, was approved by the government resolution from June 2004. The reform is implemented as a package of measures on both revenue and expenditure sides of the general government, focusing on the spending side. It is targeted at reaching a permanent reduction of fiscal deficits. The government set a fiscal target of 4 per cent government-sector/GDP ratio for 2006 and a downward trajectory of the deficit.

The marketable state debt of the Czech Republic (T-bills, domestic T-bonds and eurobonds outstanding) reached the nominal value of CZK 571.38 bln by the end of 2004. The share of short-term marketable debt (i.e. debt payable up to one year) dropped to 25.82%. At the same time, the share of T-bills in the marketable debt dropped to 21.97%. Modified duration of marketable debt reached 4.08 years including derivative operations; realized derivatives not included, this criterion would be lower by 209 days (i.e. cca 0.6 years).

The total state debt had a nominal value of CZK 592.9 bln.

The short-term state debt dropped to the level of 25.02% (while the share of T-bills in the total debt dropped to 21.17%). The active management of debt portfolio made possible to achieve the bottom level of announced medium-term target for short-term debt in accordance with the MF Issuance

Strategy for 2004 from December 9, 2003. It means that the refinancing risk of the debt portfolio has been significantly reduced as a result of the issuance policy.

The total share of the fixed-rate short-term state debt and of variable-rate state debt made 26.95% including the effect of interest rate derivatives (the interest rate re-fixing). The share of variable-rate state debt has grown to 3.5% because of further drawing of non-marketable loans from the European Investment Bank.

The modified duration of state debt including derivative operations reached 3.95 years. Its increase in the fourth quarter was caused by reduction of the amount of T-bills outstanding by CZK 21 billion and by the significant downward shift of the yield curve. Ministry of Finance hit the yearly duration target band 3.3 - 4.3 years (see the MF Issuance Strategy for 2004 from 9 December 2003). In comparison with previous years, the debt portfolio is much better insulated against interest-rate shocks.

Average life of state debt - the new strategic benchmark from 2005.

The Ministry of Finance announced for the first time the target of 5.5 to 6.5 years for the average time to maturity of state debt (average life) that should be achieved by the end of 2005 (see the Financing and Debt Management Strategy for 2005). It is another measure used for refinancing risk management. Its increase implies lower risk.

Key instruments to ensure cuts in fiscal deficit and reach the mentioned target consist in imposition of binding medium-term expenditure frameworks, which will limit the state budget's and state funds' spending within the horizon of three years and make it possible to get control over development of spending. Expenditure ceilings and rules based on medium-term decision-making will result in improved specification of spending priorities and thus also better efficiency of budget allocation. These changes have been taken into account in an amendment to the organic budget law, effective from September 2004.

Developments of the main macroeconomic indicators of the Czech economy and their forecasts are summed up as follows:

Main Macroeconomic Indicators

		2000	2001	2002	2003	2004 *Estimate*	2005 *Forecast*	2004 *Previous*	2005 *Forecast*
Gross domestic product	*increase in %, const.pr.*	3,9	2,6	1,5	3,7	3,8	3,8	*3,8*	*3,6*
Consumption of households	*increase in %, const.pr.*	2,9	2,6	2,8	4,9	2,5	2,8	*3,6*	*3,4*
Consumption of government	*increase in %, const.pr.*	0,2	3,8	4,5	4,2	-2,2	3,1	*-1,2*	*-0,2*
Gross fixed capital formation	*increase in %, const.pr.*	4,9	5,4	3,4	4,8	9,4	7,5	*9,3*	*7,0*
GDP deflator	*increase in per cent*	1,4	4,9	2,8	1,9	4,1	3,0	*4,0*	*3,1*
Average inflation rate	*per cent*	3,9	4,7	1,8	0,1	2,8	2,8	*2,9*	*3,3*
Employment *(LFS)*	*increase in per cent*	-0,7	0,4	(0,8)	-0,7	-0,7	-0,2	*-1,0*	*-0,3*
Reg. unemployment rate *(MoL)*	*average in per cent*	9,0	8,5	9,2	9,9	10,2	10,1	*10,3*	*10,3*
Wage bill	*increase in %, curr.pr.*	2,6	6,9	8,5	5,6	4,8	6,3	*5,3*	*6,2*
Current account / GDP	*per cent*	-4,9	-5,4	-5,6	-6,2	-5,8	-5,9	*-6,0*	*-5,7*

(Data on growth of employment for 2002 are given in brackets due to methodology change in Labour Force Survey.)

For seven consecutive quarters, the Czech economy's growth has been exceeding three per cent limit. At the same time, the Czech economy has been gradually catching up with the neighbouring advanced countries. In the third quarter of 2004 the Czech economy slowed a little. Quarter-to-quarter growth of seasonally adjusted GDP slowed from 1.0% in the second quarter to 0.8% in the third quarter according to CSO estimates. Growth continued to be pulled by investment and goods exports. Pace of growth of household consumption slackened.

In short-term outlook, positive effects of the Czech Republic joining the EU will be seen. Both a high dynamic of investment and vigorous growth of exports and imports are expected. At the same time, pace of growth of household consumption should stabilize. Due to economical behaviour, government consumption should have downward tendency with purchase of supersonics for the Czech army having one-off effects in the second and third quarters. This item will be seen in the same period in imports of goods and thus will have no effect on GDP growth. Year-on-year increase of GDP in constant prices reached 3.6% (compared with estimate of 3.9% in October forecast) in the third quarter. For 2005 growth of GDP is expected to keep slightly above the pace of growth of potential product. For both years 2004 and 2005 year-on-year increase of GDP is estimated at 3.8% (unchanged in 2004; 3.6% in 2005). Year-on-year growth of expenditures on final consumption of households slowed to 2.1% (3.4%) in the third quarter of 2004. Household spending was driven mainly by development of real wages. At the same time, low interest rates boosted tendencies to buy own housing, withdrawing part of the household disposable incomes. Final consumption of households is estimated to have increased by 2.5% (3.6%) in 2004. In 2005 growth of household consumption should accelerate to 2.8% (3.4%).

Government consumption fell by 5.5% (fall by 1.0%) in the third quarter of 2004. Year-on-year fall for 2004 is estimated at 2.2% (fall by 1.2%). Public finance reform is expected to lead to economical behaviour of government institutions in terms of both employment and purchase of goods and services. Nevertheless, due to the mentioned purchase of supersonics, government consumption is expected to grow 3.1% (fall by 0.2%) in 2005. Volume of gross fixed capital formation grew in the third quarter of 2004 in year-on-year terms by as much as 9.7% (8.0%). Total increase in 2004 is estimated at 9.4% (9.3%). In the years to come, high pace of growth is expected to keep up mainly due to inflow of foreign direct investments and improving financial situation of the business sphere. At the same time, foreign owners in the CR are assumed to reinvest a substantial part of profits. An increase by 7.5% (7.0%) is predicted for 2005. Certain risks for maintenance of positive development of economic output are seen in public finance whose equilibrium should be ensured by reform. Price development of oil or possibly also metals is another risk.

Prices of goods and services

After more than two years of relative stability, consumer price levels have started growing slightly again in 2004. Average rate of inflation reached 2.8% (2.9%) in 2004. December year-on-year increase was also 2.8% (3.4%) with administrative price measures contributing by 1.7 p.p. (unchanged). The change in trend was caused by many cost-related factors. An impact of increases in indirect taxation and harmonization tax adjustments connected with EU accession was an accelerating factor of consumer price growth in early 2004. Contribution of administrative measures to year-on-year price growth was higher in 2004 than in 2003 by 1.4 p.p. in total. Also price movements on the world and domestic commodity markets of raw materials and products had a significant impact.

Growth of prices of domestic agriculture producers, initiated as soon as in 2003, reflected with some delay in growth of some foodstuff prices still over the third quarter of 2004. Growth of prices on world oil and metal commodity markets generated cost pressure on growth of industrial producer prices practically all the year round. Impact of growth of dollar oil prices (on average USD 38.3 per barrel of Brent oil in 2004, which is 32.8% more than in 2003) outweighed, in the end, impact of the exchange rate of the Czech crown against the dollar (an average year-on-year appreciation by 9.8%), reflecting in growth of fuel and transport prices. With influence of harmonization adjustments from the previous year abating, no acceleration of year-on-year price growth and increase in average rate of inflation is expected in 2005. Average rate of inflation is estimated within an interval centred at 2.8% (3.3%) with contribution of administrative price measures at 0.9 p.p. (0.8 p.p.).

In the following years, impact of administrative measures will be less important depending on time of validity of exceptions agreed on under the accession negotiations with the EU and gradual completion of liberalization of prices on energy markets. Implicit GDP deflator should grow by 3.7% (3.5%) in 2004 and some 3.2% (3.3%) in 2005.

Labour market and households

Dynamic economic growth, exceeding three per cent level since early 2003, has not resulted in an improvement of labour market situation so far. Up to now, it has been accompanied by year-on-year fall in employment and growth of unemployment. In the third quarter of 2004 it was for the first time when seasonally adjusted data showed a very moderate decline in unemployment and growth of total employment. We believe however that this development reflects – with a certain delay –a shift in the economy's cyclical position while structural problems still persist, which is documented on ongoing fall in rate of participation and growth of number of economically non-active people.

Employment

Employment is estimated to have fallen by 0.7% (1.0%) in 2004. Ongoing year-on-year decline in employment (0.2% in the third quarter) with dynamic economic growth stems from two principal causes2. First, businesses prefer high-quality minimum employment and struggle for further growth of productivity and, second, some segments of population are passive and difficult to be employed. Due to an increase in not only minimum wage but also in subsistence level from 1 January 2005, no change in behaviour of risk categories can be expected without taking supplementary measures.

Ongoing shrinkage of employment in manufacturing industry and reduction in number of employees in public administration, army forces and education had the most substantial impact on fall in employment. Biggest increases were observed in transport and storing, and education. In the third quarter a moderate increase of employees was seen while number of members of production cooperatives and entrepreneurs continued falling. Although shrinkage of workforce in essence stopped in the third quarter, number of persons in productive age was still growing and rate of economic activity thus further decreased.

Fall in employment is expected to slow to 0.2% (0.3%) in 2005.

Unemployment[3]

Rate of registered unemployment reached on average 10.2% (10.3%) in 2004 with a December value of 10.3% (10.4%). Seasonally adjusted data reached historic maximum of 10.4% in March 2004 while subsequent decline stopped at 10.0% in October. Our forecast is therefore cautious. Changes in registered unemployment were affected as by employment developments as by administrative measures – in particular, programmes of active employment policy (AEP, mainly intensified assistance to school-leavers and persons endangered with loss of working habits) and an amendment to the Employment Act. Number and share of the long-term unemployed is still growing in year-on-year terms. However, due to AEP measures (in particular in the most problem regions), an overall tendency toward fall in their number can be seen in the second half. Nevertheless their increase especially in the age category of 20 – 29 years still warns. Number of the registered unemployed is expected to fall slightly in 2005. Effects of economic growth and AEP should outweigh the structural deficiencies of the labour market. However, it will be necessary to pay maximum attention to adjustment of social benefit system aimed at boosting motivation to work to the utmost degree. Regional differences in rate of unemployment should persist due mainly to qualification discrepancy in supply and demand for labour force in problem regions. Due to differentiated support of creating new jobs and employment offices' active approach, differences should not nevertheless increase. Consequently, a slight fall of rate of unemployment to a December value of 10.2% (unchanged) is expected in 2005 with an average value of 10.1% (10.3%).

Households[4] (National accounts methodology)

Growth of average wages in the business sphere is in principle continuous in dependence of the firms' economic situation. However, changes in a structure of salaries and marked cuts in extra items in the budgetary sphere resulted in considerable fluctuations of the average wage in the non-business sphere during the year. Slowdown in wage bill growth within the national accounts reflects ongoing reduction of number of employees affecting also higher salary categories in 2004. Social benefit bill grew more slowly in year-on-year terms, due mainly to lower indexation of pensions in spite of resumed growth of disability and early retirements. Health insurance benefits have fallen significantly in year-on-year terms. It is mainly low interests on deposits that motivate households to higher consumption. Under recalculated data, gross saving rate goes on falling in year-on-year terms. Nominal increase in wage and salary bill for 2004 probably reached 4.8% (5.3%) and it is estimated at 6.3% (6.2%) for 2005. Growth of social benefit bill for 2004 and 2005 is estimated at 3.7% (4.2%) and 5.5% (6.0%), respectively.

Savings and investments

Since mid-1998 a monotonous fall of ratio of gross national savings to GDP could be observed from nearly 27% to 21.1% in 2003. This unfavourable phenomenon stopped in 2004 due to increased formation of savings in government sector and non-financial institutions. As regards share of individual sectors in current account deficit (considering the difference between savings and investments), efforts to stop worsening of the government sector financial balance were successful thanks to the general government measures. The current high dynamics of investment in the non-financial sector should abate in the next period and bring no risk in terms of external imbalance.

Demographic trends[5]

In terms of workforce resources, the current demographic structure is obviously the most favourable over the entire history backed up with demographic data. Under the Czech Statistical Office´s projection, share of population in the age group of 20-59 should reach the record level in 2005. This category includes numerically strong age groups born immediately after the World War II as well as strong generations of the seventies and eighties. On the other hand, numbers of young people are falling and numbers of 60-plus seniors are increasing. From the dynamic point of view, we witness a beginning of population-ageing process. Share of young-age categories will go on reducing. It results from the past and present extremely low birth rates related not only with a change in lifestyle but also with a very poor availability of housing for young families. On the other hand, number and share of seniors in population will grow thanks to demographic structure and extending average life expectancy. Unfavourable development can be partly mediated by international migration with the Czech Republic becoming the target country. Demography represents a risk for the economy's developments in the medium and long run.

To mediate the unfavourable effects of population ageing, parametric reform measures have been adopted. Preferential treatment of early retirements and disadvantaged treatment of delayed retirements were eliminated. Up to 2013, gradual extension of minimum retirement age is ensured. Under public finance reform, further changes were made – abolition of the temporarily reduced early retirements, indexation of pensions only to the extent set by the law etc. However, since late 2003 the number of old-age pensioners (especially in the early retirement category) has been increasing again.

Due to population ageing, deficit tendencies on the pension account will be deepening in the traditional pay-as-you-go system in the future. That's why a common commission of experts and representatives of parliamentary parties has been established to propose a rational and politically feasible solution of the pension reform.

Interest rates

In August 2004, the Czech National Bank set its policy rates as follows: 2T repo rate at 2.50%, discount rate at 1.50% and Lombard rate at 3.50%. In 2004 a gradual increase in inflation was seen, based mainly on tax changes, growth of world commodity prices and recovery of domestic, European and world economies. Similar rate of inflation, albeit without marked administrative interventions, is expected also in 2005. Yield curve of PRIBOR rates moved again to higher level after the past change in policy rates but fell a little in late 2004 and the difference between the longest and shortest rates reduced. Its positive slope along the whole curve thus persists signalling expectations of further increases in policy rates by financial markets but much more sedate than in the previous period. An average rate of PRIBOR 3M is estimated at 2.4% (unchanged) in 2004 and at 2.8% (2.7%) in 2005. Yield to maturity of 10-year governments bonds for convergence purposes[6], which is substantially influenced by the extent of state bond issues including eurobond issues, but mainly by bond trading on foreign markets, is estimated at 4.8% (unchanged) in 2004 and at 4.5% (5.3%, i.e. return to the last but one estimate). In the forecast period, client interest rates[7] will grow with certain time delay depending on potential increase in CNB policy rates and subsequent growth of inter-bank market rates. Average rates of demand deposits and one-day deposits of non-financial sectors are assumed to have reached 0.6% in 2004 and to reach the same level in 2005 (forecast lowered). Rates of fixed-maturity deposits reached on average some 2.0% over 2004 and will grow slightly in 2005, reaching 2.3%. Interest rates of loans to non-financial sector should reach 6.0% in 2004 and 6.2% (6.5%) in 2005.These are estimates under the new methodology and rate of uncertainty is a product of only a short-term experience.

Monitoring of Other Institutions' Forecasts

The Czech Ministry of Finance monitors macroeconomic forecasts of other institutions, engaged in forecasting of future developments of the Czech economy. Forecasts of 14 institutions are continuously monitored from publicly available data sources. Of these, 8 institutions are domestic (CNB, domestic banks and branches of foreign banks, investment companies) and others are foreign (European Commission, OECD, IMF, the Economist panel, foreign banks). The forecasts are summed up in the following table:

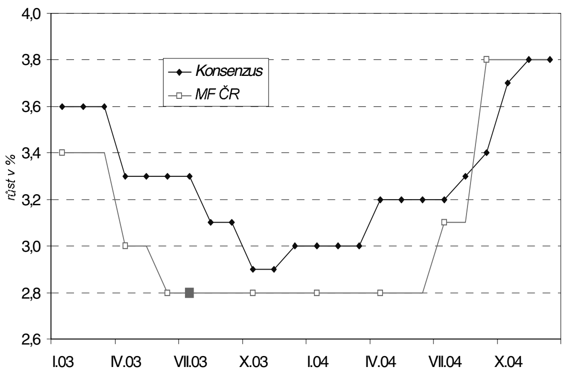
Consensual Forecast

		December 2004			January 2005
		min.	max.	consensus	forecast MoF
Gross domestic product (2004)	%, const.pr.	**3,3**	**4,4**	**3,8**	**3,8**
Gross domestic product (2005)	%, const.pr.	**3,4**	**4,5**	**4,0**	**3,8**
Average inflation rate (2005)	%	**2,4**	**3,2**	**2,8**	**2,8**
Unemployment rate (2005)	%, end of year	**9,3**	**10,0**	**9,7**	**10,2**
Current account / GDP (2004)	%	**-6,5**	**-5,4**	**-6,0**	**-5,8**
Current account / GDP (2005)	%	**-6,7**	**-4,0**	**-5,5**	**-5,9**

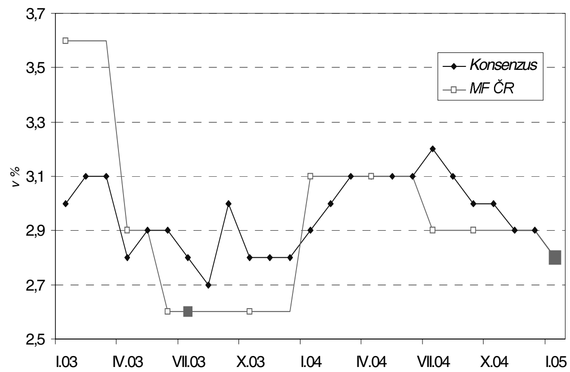
Forecasts of GDP growth are in tune: 2005 should not bring any worsening compared with 2004. More than one third of institutions allows for the same values for both years while others provide for a very slight growth of dynamics.

Forecasts of average rate of inflation for 2005 are interestingly inconsistent. Czech institutions but one expects a moderate fall by some 0.2 p.p. compared with the previous year while foreign institutions expect, similarly as the MoF, stable inflation. Forecasts of rate of registered unemployment for 2005 agree that the situation will be more favourable than in the previous year. However, the MoF is by 0.5 p.p. more pessimistic than the consensus, which stems from the fact that the MoF forecast takes into account the December result, which was worse than expectations of other monitored institutions. As regards ratio of the current account of balance of payments to GDP for 2004 and 2005, an agreement prevails (exclusive of two institutions) that this indicator should improve by approximately 0.5 percentage points. By contrast, the MoF expects a slight worsening in 2005. But it is not quite clear to what extent the individual institutions have taken into account the expected import of military aircraft in 2005, significant in macroeconomic terms, which will worsen current account balance by some 0.6 p.p. of GDP.

Forecasts of GDP growth in c.p. for 2004



Forecasts of inflation rate. for 2004



(Note : Periods on axis x express forecast releases. Highlighted symbol in the MoF forecast from June 2003 indicates the period of cut-off date in preparation of the Macroeconomic Framework of the 2004 State Budget. Besides, in the graph of inflation rate forecasts a final outcome, which was released in January 2005, is highlighted.)

2. Supply and Demand of Housing

At the central level, housing policy is in the jurisdiction of the Ministry for Regional Development. Some specific aspects of the housing policy are in the jurisdiction of the Ministry of Finance (regulation of rent and prices of heat, electric power, water, etc.) and the Ministry for Labour and Social Affairs (social allowances). The central government plays a key role through the establishing of the general legal and economic framework for housing. At the local level, housing is in the jurisdiction of individual municipalities (the Czech Republic has over six thousand municipalities); however, their role has not been defined in an unequivocal manner.

The Government's role is based on the notion that the state's role in the area of housing is using legal and economic instruments to create a situation where people are able to secure adequate housing, either by their own means or with the state's assistance. Such a model conforms fully to the market-oriented approach to housing used in all European Union Member States, and it allows people to exercise the right to housing which the Czech Republic has agreed to ensure under various international agreements. Thus, the basic objective of the state's housing policy is creating conditions under which every household is able to secure adequate housing corresponding to its needs and financial situation. Efforts are concentrated especially on improving the financial accessibility of housing, increasing the availability of housing, and improving the quality of housing stock. Other plans the Government has in respect of housing include eliminating economic and legislative barriers which hinder the functioning of the market, improving the existing system of legal and economic intervention instruments with the aim of increasing their effectiveness and efficiency, emphasizing the role of private funds in the housing sector, reducing the role of the state, and increasing the responsibility of individual households for securing adequate housing.

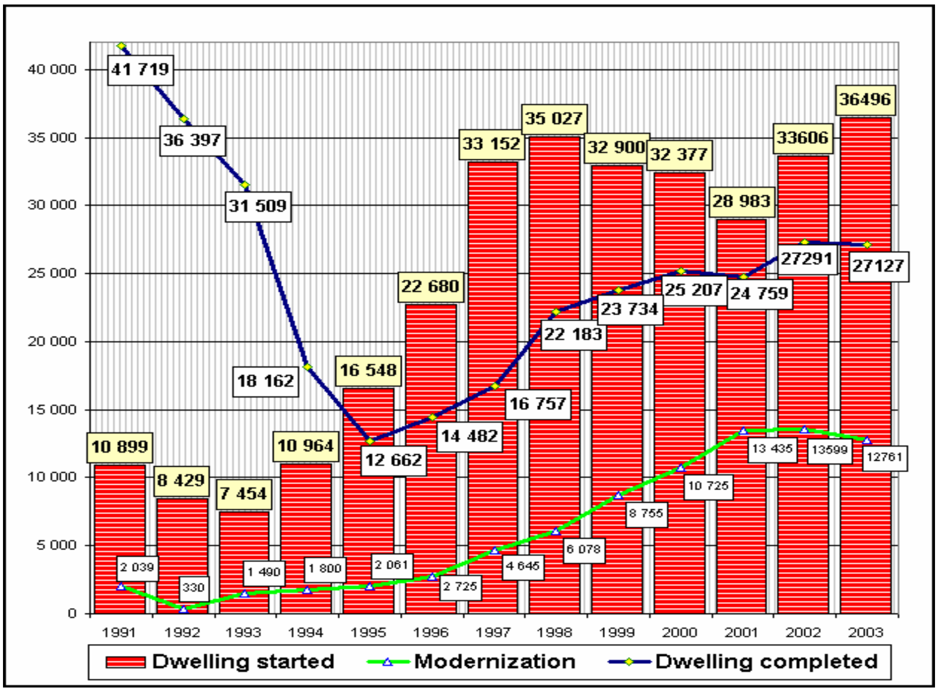
While private individuals own 86% of permanently inhabited buildings, municipalities and the state are the proprietor of only approximately 5% and cooperatives of about 3% of such buildings. Private individuals own 97% of permanently inhabited family homes. Municipalities and the state owned in 2001 an important number of permanently occupied housing stock (approximately 29%). Private individuals own some 15% of permanently occupied housing stock. Most buildings are made of bricks and profilated bricks (60.8% of all permanently occupied buildings) as well as stone and brick (26.5%). However, wall panels are used in 34% of permanently inhabited buildings. Only 1.4% of permanently occupied buildings have no running water, and 25.8% have no district or central heating.

Construction of new housing takes place mainly in the sector of privately-owned dwellings, that is privately-owned family homes and condominiums in apartment buildings. The volume of construction of rental housing is relatively low; this form of housing is developed only by municipalities which construct rental housing with the state's support consisting of direct investment subsidies. There is almost no construction of cooperative housing. Revitalization of this sector is expected after the introduction of measures consisting of subsidies targeting construction of cooperative housing which were prepared by the Ministry for Regional Development and approved by the Government in October 2004.

Construction of privately-owned housing mostly relies on mortgage financing, construction savings plans, and loans. The volume of construction activity differs from region to region. The highest number of new houses are built in Prague, its vicinity, and areas characterized by an abundance of employment opportunities, high incomes, etc. In dynamically developing regions (Prague and some other cities), construction of new housing is fully comparable to the extent of construction activity in EU countries. As the purchasing power of the population increases, so does the price of new housing. In the past two years, the price of condominiums and family homes has increased in expectation of the fact that real estate prices would grow after the Czech Republic joins the European Union. However, the prices stopped increasing already in 2004, and the prices of some older dwellings, especially those in prefabricated-panel buildings, decreased considerably.

One problematic area is a relatively low volume of constructed rental housing (insufficient in respect of the needs of low- and middle-income households). Rental housing is built almost exclusively with government subsidies, since the private sector is not interested in this area, mainly due to the fact that rental housing entails a long period of return on investment in contrast to privately-owned dwellings. A negative role is also played by long-term rent control measures and unbalanced distribution of the rights enjoyed by landlords and tenants. Measures of support can be divided into two basic groups according to the financing method. The first group relies on special-purpose investment subsidies for construction of rental housing by municipalities and buildings where social services are provided; this form of support is not directly tied to financing from other sources. The second group includes support in the form of interest subsidies, loans, and repayable contributions, and it is directly related to loan financing. The second group also includes construction savings plans in cases where people use a construction savings loan or combine the use of construction savings with another type of loan.

New housing construction



Assessing the effectiveness and efficiency of programs intended to support construction of new housing up to 2002 was very difficult, if not impossible. The main reason was the fact that instruments of support, as they were conceived, did not meet the usual requirements for program-based financing, preventing evaluation of their benefits. The problems which programmes aimed to resolve were not identified in an unequivocal manner, and individual programs did not have a clearly defined objective. In many cases, the target group at which support was aimed was not identified. In addition, programs lacked transparent and measurable criteria for assessing their economic and objective effectiveness. This approach resulted in a situation where assistance was almost always disbursed based on demand and not on clearly defined needs. These conditions understandably resulted in a high demand for subsidies. Effective allocation of public funds, however, should not rely on such indefinite parameters. For this reason, programmes changed fundamentally in 2003, their target groups were defined in a clear manner, and their use was made conditional on setting exact technical and financial parameters. The goal was to ensure as economical use of public funds as possible.

The above shortcomings of measures intended to support housing constructions were the product of the environment in which they were created and applied. Due to the fact that the transformation process has not been completed, the Czech economy is not functioning entirely as an established market economy. Individual market parameters (such as price) do not yet fulfil their economic role and do not provide sufficient information that would allow making effective decisions on the market. For example, the fact that the information function of rent (regulated in almost one third of housing stock through a maximum price) is reduced to an accounting category is detrimental to the effectiveness of expenditure programmess, regardless of how specifically the conditions for disbursement of assistance are conceived.

A social housing sector in the form usual in a number of Western European countries does not exist in the Czech Republic. Privatization, i.e. sale of dwellings to individuals/existing tenants, has been used with regard to municipal housing stock, formerly state-owned, which has been transferred to municipalities gratuitously at the beginning of 1990s. Deciding to privatize buildings and determining for what price they are sold is in the jurisdiction of the elected representatives of individual municipalities. There is no "right to buy," and dwellings are usually sold for a low price, taking into account the fact that maintenance has been neglected in most buildings. The privatization process also applies to the cooperative sector where it encompasses cooperative dwellings built with state assistance in past decades. Considering the fact that the users of these cooperative dwellings have had to repay construction loans as part of rental payments, dwellings of this type are transferred without payment. In both cases, housing is privatized in accordance with the Act on Ownership of Dwellings (ownership of condominiums).

Overall, approximately CZK 25 billion is paid annually from the state budget and the budget of the State Housing Development Fund, a sum that corresponds to more than 1% of GDP. Combined with indirect subsidies, i.e. tax deductions and exemptions, state support translates to some 1.5% of the GDP. Public support includes expenditures of municipalities, especially funds spent on construction of rental housing and repairs of housing stock.

Housing expenditures burden households in an increasing manner. This trend is the result of deregulation and an unbalanced development of prices; a role has also been played by the decreasing of the average household size. Compared to 2003, household housing expenditures grew in 2004, affecting especially senior citizens and low-income households. An important part of housing expenditures is the cost of energy; for example, for households living in rental accommodation, energy-related expenses account for more than a half of all housing expenditures. In 2004, the proportion of housing expenditures and total net cash household expenditures totalled 18.4% in average households, 25.4% in household of senior citizens, and 23.7% in low-income households with children. Housing expenditures of these households totalled 17.2%, 25.3%, and 24.2%, respectively, of their net income. The proportion of housing expenditures paid by households inhabiting rental dwellings is slightly higher—20.2% for average households, 26.8% for households of senior citizens, and 28.9% for low-income households with children. In like manner, housing expenditures of these households totalled 19.4%, 28.9%, and 30% of their net income, respectively.

The development of housing construction costs in recent years and a regional comparison are shown in enclosed tables and graphs. The acquisition price of new dwellings range between some CZK 17,000 to 28,000 per square meter of efficient area of a dwelling. The acquisition price per one square meter of efficient area of a dwelling differs considerably, especially depending on the number of floors and structure of dwellings (and the corresponding cost of technical installations and facilities). Prices on the market differ substantially depending on the local supply and demand. For example, the price of an older dwelling in a large-panel prefabricated (30 years old) panel building in Prague totals approximately CZK 1,300,000, while the same apartment costs as little as CZK 160,000 in cities affected by high unemployment, low purchasing power, and low demand.

Housing stock structure

	housing stock total		of which					
			family houses		apartment buildings		others	
	abs.	in %	abs.	in %	abs.	in %	abs.	in %
Buildings total	1 969 568	100,0	1 732 519	100,0	196 430	100,0	40 619	100,0
permanently inhabited	1 630 705	82,8	1 407 248	81,2	194 826	99,2	28 631	70,5
uninhabited	338 863	17,2	325 271	18,8	1 604	0,8	11 988	29,5
in uninhabited buildings-dwellings	353 296	x	331 708	x	9 000	x	12 588	x
Permanently inhabited buildings	1 630 705	100,0	1 407 248	100,0	194 826	100,0	28 631	100,0
Owner								
private natural person	1 397 923	85,7	1 362 175	96,8	28 703	14,7	7 045	24,6
municipality,state	79 066	4,8	12 335	0,9	55 506	28,5	11 225	39,2
housing cooperative	41 808	2,6	2 900	0,2	38 908	20,0	-	-
another	103 613	6,4	24 461	1,7	70 849	36,4	8 303	29,0
Period of construction								
1899 and earlier	135 218	8,3	118 141	8,4	12 161	6,2	4 916	17,2
1900 - 1945	446 041	27,4	398 460	28,3	40 226	20,6	7 355	25,7
1946 - 1970	354 229	21,7	285 860	20,3	64 389	33,0	3 980	13,9
1971 - 1990	500 795	30,7	431 592	30,7	64 303	33,0	4 900	17,1
1991 and later	171 092	10,5	154 936	11,0	11 448	5,9	4 708	16,4
Material of supporting walls								
bricks, breeze blocks	991 080	60,8	875 362	62,2	102 551	52,6	13 167	46,0
stone and bricks	432 181	26,5	400 149	28,4	22 257	11,4	9 775	34,1
wall panels	79 867	4,9	12 695	0,9	65 457	33,6	1 715	6,0
others	113 088	6,9	107 745	7,7	3 677	1,9	1 666	5,8
Water main								
in the house	1 594 743	97,8	1 373 784	97,6	194 598	99,9	26 361	92,1
outside the house	2 514	0,2	2 460	0,2	14	0,0	40	0,1
without a water main	22 271	1,4	21 936	1,6	73	0,0	262	0,9
Central heating								
remote or block boiler source	98 473	6,0	9 360	0,7	85 482	43,9	3 631	12,7
boiler room in the house	1 093 700	67,1	1 047 022	74,4	32 243	16,5	14 435	50,4
without distance and boiler	420 416	25,8	336 245	23,9	75 899	39,0	8 272	28,9

3. Housing Finance Market

Thanks to competition pressures from mortgage banks and low interest rates, mortgages are becoming a commonplace method of financing construction of family homes and condominiums. As to the value of monthly mortgage instalments paid by households and the overall volume of repaid funds, the most important factor are long-term interest rates on mortgages. Even though the base commercial interest rates have been declining steadily in the past two years, the number of households able to obtain a mortgage is limited, chiefly due to the high cost of new housing. Another restricting factor is the unwillingness of households to assume long-term debt. Nonetheless, the importance of this factor is decreasing, as the volume of loans is increasing overall—Czech families are less and less afraid of living on credit, and acquisition of items of long-term consumption is becoming a normal part of life, similarly as in Western countries. The credit standing of an applicant for a mortgage is usually considered sufficient if the applicant's family is left with a 1.8-2 times the subsistence minimum after mortgage instalments are subtracted from the household income—this sum corresponds to a net monthly income of CZK 20-30,000, depending on the household size. In this regard, debtor registries are becoming increasingly important; they register debtors and their credit habits, including payment of telephone bills, utility bills, etc.

Mortgage finance and housing saving schemes[8]

Both mortgage finance and housing savings schemes were introduced in the Czech Republic relative early, in the first half of 1990s. Following the decrease in nominal interest rates in the second half of

1990s and adjusting them by inflation and state subsidies (interest subsidy and tax relief on interest from housing loans) the sharp development in loan financing of home purchases has been expected at the end of 1990s and beginning of new century. However, though new loan products became more popular their use in practice developed much more gradually and slowly than it was previously expected.

The effectiveness and efficiency of housing savings schemes started to be questioned already several years ago but due to the gap in data no profound evaluation of the system has been done till now. According to the estimates of the Association of Housing Saving Banks, only about 30% of clients take the loan when they finish the saving part of the scheme. It is necessary to stress the fact that if a client does not ask for the additional loan at the end of the saving period he/she can use savings for different purposes, i.e., also other than housing. However, they do not loose the right for generous state premiums distributed on their saving accounts each year. Housing purpose is asked only when the loan is extended. There is thus guarantee that only 30% of clients of banks will use the state subsidy for housing and there is no information about the rest of them to check for efficiency of the whole system.

In co-operation with the private company Ronney&Benett, the special questionnaire survey New housing 2003 has been conducted by the Institute of Sociology on the sample of respondents buying new dwellings in Prague in 2003 (N = 138). Two development projects have been selected, one being labelled as „standard“ and one as „luxurious“ in relation to their location, size and quality of furnishment. As the result figures shows, the majority of respondents financed purchases of their new homes from several distinctive resources (82.5%) and only 17.5% of respondents exclusively from one source (mainly own savings). The ranking of financial sources to purchase new homes according to their share on total values of new dwellings was still dominated by own savings (38.5% of dwelling value in average), followed by mortgage loans (32.8% of dwelling value), housing savings (including loans from housing saving schemes, 8.9% of dwelling value) and gifts from relatives (8.8% of dwelling value). More than 55% of costs were still covered from own savings or family financial help and only one third of costs were, in average, covered by mortgage loans. Moreover, housing savings did not form the substantial part in the total sum at all, which is, in context of high state subsidy expenditures, at least unbalanced. However, these were flats relatively very expansive and in the most expensive town of the country. The share of housing savings on total sum of financial sources used for the dwelling purchase may be more substantial when buying older dwellings and, especially, in regions with relatively low average house prices (region of the North Bohemia).

There was another very interesting finding from this survey. The financing of purchase through own savings or family help is more characteristic for dwellings sold from luxurious project than those from standard project. This is also the reason why the average share of mortgage loan on total sum of finance used for purchases of dwellings from luxurious project is much lower than the same share in case of standard project (28.4% versus 42.5%). The same applies when we look at simple frequentations, i.e., the number of respondents taking the mortgage loan with no regard to its amount. Only 46% of respondents from luxurious project used mortgage loan at all while this was more than 65% of respondents from a standard development project. As respondents buying the properties from luxurious development project are of higher income the hypothesis occurred that the correlation between income and probability of taking the mortgage loan is not a linear one. However, it was confirmed that there is statistically significant linear relation between income and using of mortgage finance and the only factor influencing the divergence is higher family help in case of luxurious flats. This finding just shows that even when quite expensive dwellings are bought the mortgage loans are not more present as primal financial source than in case of less expensive dwellings and, in fact, the opposite may be true. This is mainly caused by an inherited inter-generation family help cultural pattern and the mortgage loan may still be perceived as the last alternative used only when family help is not available.

There is a statistically significant relationship between the use of mortgage loan and future mobility aspirations. Those who used the mortgage loans for current purchases (both from luxurious and standard development projects) wanted statistically less to move from this new flat and/or use another mortgage loan for future purchases than those who did not use it. Among potential clients of mortgage industry in the future are thus especially those who do not have any mortgage loan now. This may be quite important though the interpretation of this fact cannot be confirmed by an additional data analysis. However, we think that this situation is mainly caused by the constraints present in the mortgage finance system.

In the questionnaire survey Housing Attitudes 2001 conducted on national representative sample of respondents in 2001 (N = 3,564) the Institute of Sociology asked respondents about the past and future mobility as well as about the financial sources used to cover the purchase price and transaction costs. Among those, who have moved since 1995 till 2001 to home-ownership from different tenures (n = 469) only 6.9% mentioned mortgage loan as the primary source to finance the costs of purchase and 19% mentioned the housing savings schemes. More than 36% of respondents selected own savings as the main source and 21% as family help (financial help or heritage). For those intending to move during the next three years to owner-occupied dwelling with no regard to current tenure (2001-2004, n = 232) the figures for market-based housing finance are more optimistic but still remain relatively low when compared with some other European countries: 14% of those intending to move mentioned the mortgage loan and 31% housing savings as the primary source while the role of own savings decreased to 20% and family help (gifts and heritage) to 13%. However, it is necessary to mention, that the survey did not ask about the potential loan volumes that could remain relatively low. As demonstrated by results from the survey New Housing 2003, 52% of buyers took the mortgage loan but these covered, on average, only 33% of a value of dwelling. The conclusion may be drawn that though there was not very common use of market-based housing finance in the second part of 1990s and beginning of a new century, there are good prospects for these finance products in the future. However, even in the future the development will be probably again rather gradual then sharp. When we look at the real interest rates on mortgage loans offered by mortgage lenders adjusted for subsidy and inflation we must definitely conclude that though „it goes well it goes very very slowly.“ This is conclusion relatively known from other transitional countries too.

It is often stated that mortgage loans are not affordable for major part of population. According to the Housing Attitudes 2001 survey, slightly more than 4% of respondents had had a mortgage loan in the past or had the mortgage loan in 2001. Another 8% of respondents would like to use it in the future and almost 78% do not think they will use it anytime in the future. The reply to this question is naturally very strongly correlated with the household income.

Mortgage loans in total (as of June, 2004)

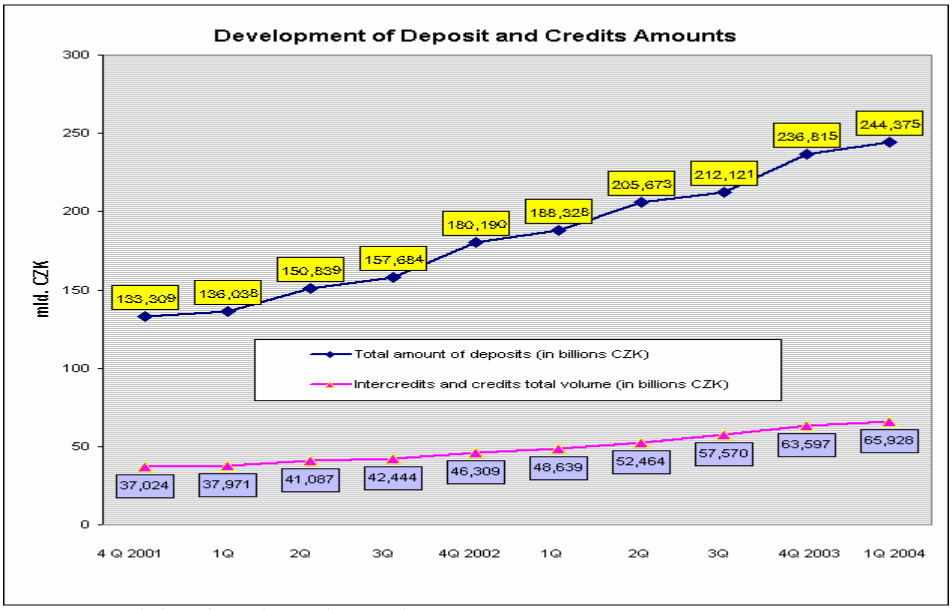
Loans for:	Private individuals		Enterprises		Municipalities		**Total**	
	Total number of loans	Total principal (CZK thousand)	Total number of loans	Total principal (CZK thousand)	Total number of loans	Total principal (CZK thousand)	Total number of loans	Total principal (CZK thousand)
to 31.12.2000	29 560	28 963 045	1 978	26 330 447	372	3 130 608	31 910	58 424 101
from January to March 2001	2 656	2 788 436	70	895 710	41	387 600	2 767	4 071 746
to 31.3.2001	32 216	31 751 481	2 048	27 226 157	413	3 518 208	34 677	62 495 847
from January to June 2001	5 774	6 032 421	180	2 797 232	75	643 687	6 029	9 473 340
to 30.6.2001	35 334	34 995 466	2 158	29 127 679	447	3 774 295	37 939	67 897 441
from January to September 2001	10 271	10 610 934	358	7 538 730	93	846 071	10 722	18 995 735
to 30.9.2001	39 831	39 573 979	2 336	33 869 177	465	3 976 679	42 632	77 419 835
from January to December 2001	14 250	14 728 423	457	8 922 337	130	1 159 589	14 837	24 810 349
to 31.12.2001	43 810	43 691 468	2 435	35 252 784	502	4 290 197	46 747	83 234 450
from January to March 2002	4 064	4 431 033	80	443 243	28	326 640	4 172	5 200 915
to 31.3.2002	47 874	48 122 501	2 515	35 696 027	530	4 616 837	50 919	88 435 365
from January to June 2002	9 322	10 010 300	201	3 170 838	54	711 897	9 577	13 893 036
to 30.6.2002	53 132	53 701 768	2 636	38 423 622	556	5 002 094	56 324	97 127 486
from January to September 2002	14 795	15 766 142	303	4 582 225	87	1 014 822	15 185	21 363 189
to 30.9.2002	58 605	59 457 610	2 738	39 835 009	589	5 305 019	61 932	104 597 639
from January to December 2002	21 002	22 532 310	430	6 543 409	113	1 234 448	21 545	30 310 167
to 31.12.2002	64 812	66 223 778	2 865	41 796 193	615	5 524 645	68 292	113 544 616
from January to March 2003	6 318	6 990 597	141	1 287 009	17	338 273	6 476	8 615 879
to 31.3.2003	71 130	73 214 375	3 006	43 083 202	632	5 862 918	74 768	122 160 495
from January to June 2003	13 688	15 509 927	298	5 006 119	32	524 248	14 018	21 040 294
to 30.6.2003	78 500	81 733 705	3 163	46 802 312	647	6 048 893	82 310	134 584 910
from January to September 2003	22 476	25 799 295	452	7 550 099	49	665 688	22 977	34 015 082
to 30.9.2003	87 288	92 023 073	3 317	49 346 292	664	6 190 333	91 269	147 559 698
from January to December 2003	31 478	36 212 394	626	10 580 917	61	803 636	32 165	47 596 947
to 31.12.2003	96 290	102 436 172	3 491	52 377 110	676	6 328 281	100 457	161 141 563
from January to March 2004	8 826	10 779 150	132	2 619 915	16	157 886	8 974	13 556 951
to 31.3.2004	105 116	113 215 322	3 623	54 997 025	692	6 486 167	109 431	174 698 514
from January to June 2004	20 699	25 625 597	326	8 389 146	37	510 128	21 062	34 524 871
to 30.6.2004	116 989	128 061 769	3 817	60 766 256	713	6 838 409	121 519	195 666 434

(Source: Ministry for Regional Development)

The respondents were also asked whether the mortgage loans are affordable for them and their family: while we expected that those who have already used it or currently use it would reply that a loan is affordable for them, we posed this question only to those respondents who selected other alternatives. Surprisingly, only 37% of those who would like to use the mortgage loan in the future stated that it is affordable for them and, similarly, these were only 10% of those who do not think they will use it anytime in the future. By a subjective perception there were thus only 15% of respondents for which the mortgage loan seemed to be affordable in 2001. Though more ”objective“ measurement of affordability (by, for example, using bonity criteria of dominant lenders and comparing them with reported household income) would give us a more optimistic picture, the subjective perception is very important as it reflects the real attitudes of population towards this particular financial product. Such a reflection may include the adversity to long-term credit repayment commitment, lack of information about the mortgage financing and, of course, unwillingness to pay high share of income on housing costs and, due to that, reduce the consumption of other goods because of housing expenditures.

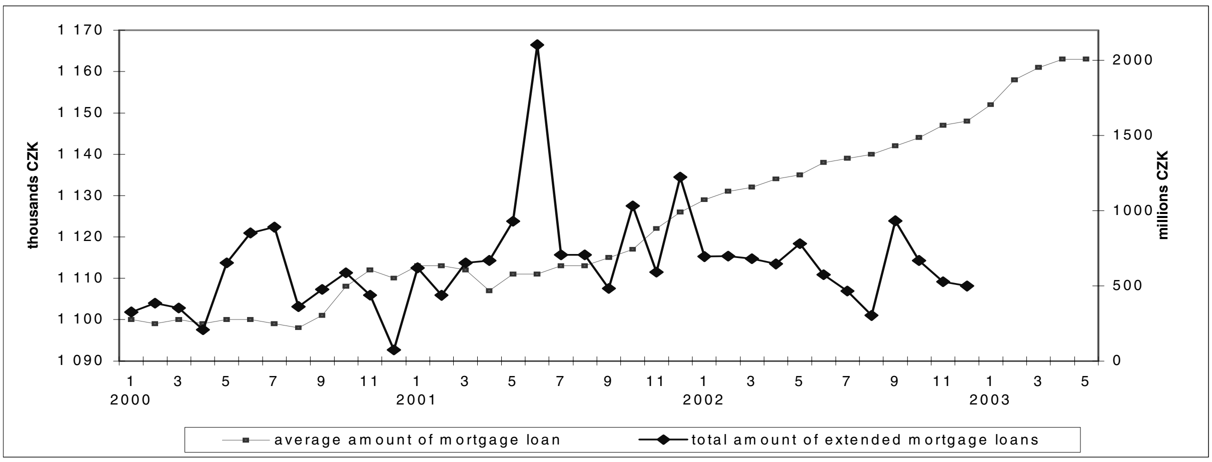
Another often mentioned reason is a specific cultural pattern based on family help expectations and an averse to long-term lending. The significance of family help expectations has been already confirmed by above mentioned figures and the averse to long-term lending may be clear when we look at the development in using of different market-based housing finance products. We might see from prospective financing of home purchase in the future that housing savings became more popular as primal source for acquiring of a new home than mortgage loans. The reason may be that the loan from housing saving bank is often only partial and presuppose some proceedings savings. Therefore, the final credit due is not so high (also repayment period and repayment amount for typical loan from housing savings scheme is relatively low). If the loan amount was not high, the bank would not ask for mortgaging the property and buyers may perceive it as a more safe option because they do not risk loosing their house in the future. Though there was no special research on risk averse or mortgage financing perception among Czech population, it is highly probable that large part of population are still very afraid of long-term credit commitment and do not want to take a risk of loosing their homes in the future. Finally, rent regulation is very often stated as one of the reason why people prefer to use the „privileged" rental tenure than move to home-ownership and use market-based housing finance for this purpose. The rent regulation in the Czech Republic is relatively flat and deeply social unjust as described fully by many experts.

Housing savings



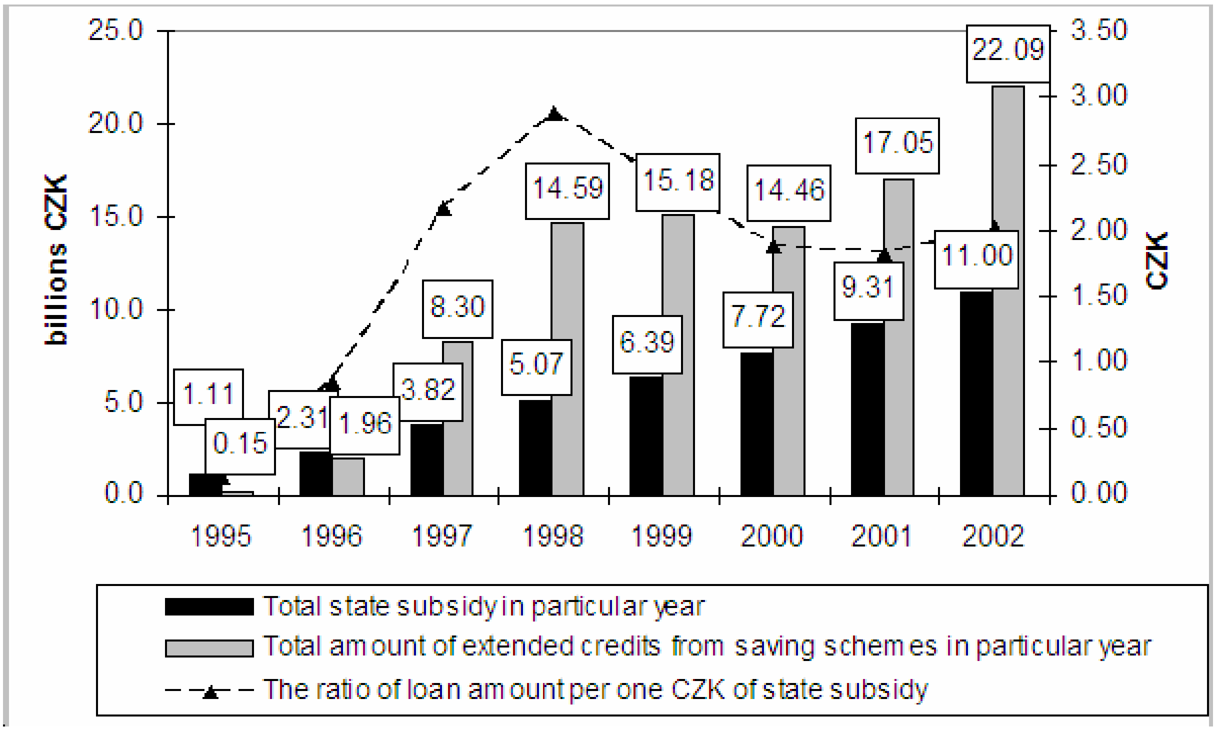
(Source: Association of Housing Savings Banks)

State subsidies to housing savings schemes and amount of housing loans from scheme (for all savings banks, in billions CZK)

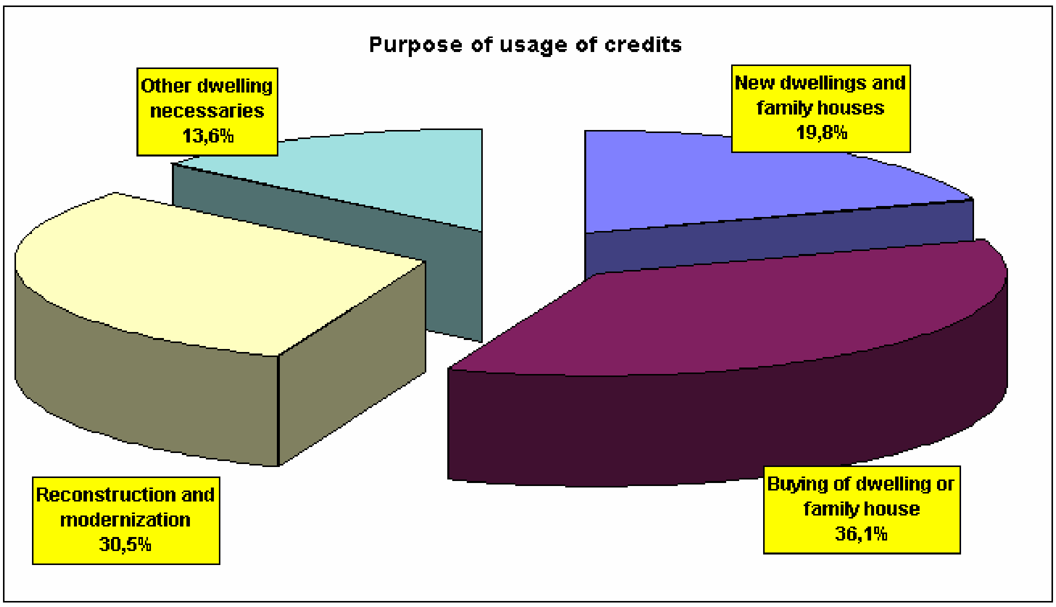


(Source: Czech Banking Association)

Average amount of mortgage loan with state support for physical persons (in thousands CZK) and total amount of extended mortgage credits with state support (in millions CZK) 2000 – 2003



(Source: Association of Housing Savings Banks, own calculations.)



(Source: Czech Banking Association, Ministry for Regional Development)

4. Housing Policy

In March 2005, a new Housing Policy Concept was approved by the Government as a strategic governmental document with the mid-term period by the year 2010. The housing policy is affected by an underway reform of public finances and the resulting pressures to reduce mandatory expenditures. Housing expenditures are delimited by a mid-term framework of expenses which will apply to the budgets of both the Ministry for Regional Development and the State Housing Development Fund (the latter was created in the year 2000 and functions as another source of public funds in the area of housing in addition to the state budget). This measure will result in the consolidation of the ensemble of support instrument and elimination of fluctuations due to the setting of budget expenditures on a year-to-year basis. Disbursement of public funds will include regular assessment of the effectiveness, efficiency, and economic feasibility of individual expense programs.

At the beginning of 2003, two new programs intended to stimulate development of social rental housing were introduced. The first concerns so-called supported housing which is focused on disadvantaged and vulnerable individuals who face specified housing problems. The other targets households with average and below-average incomes. Both programs allow municipalities to build new rental housing for the specific target group of needy families; however, their social function will be temporarily weakened because both housing types will be unable to compete with rental housing where regulated rent is below cost.

It means that social housing leased for cost (non-profit) rent, which is common in advanced European countries, can be fully developed only after a certain transitional period. Only then, it will be possible to eliminate the exemption concerning application of the reduced VAT rate on all housing construction, and the reduced rate will be used only for social purposes, as is usual throughout the European Union. The temporary application of the reduced VAT rate (by the end of 2007) on housing construction is therefore part of the overall strategy of rectifying prices on the housing market.

The second transitional period, which the Czech Republic has negotiated with the European Union at the request of the Ministry for Regional Development, concerns acquisition of housing for secondary residential purposes. Since older real estate is less expensive in the Czech Republic than in neighboring countries, the transitional period is intended to prevent speculative acquisition of housing stock and land—taking advantage of the disproportionate costs—and ensure that such real estate is permanently used for the purpose for which it is intended. By the May 2009, foreigners will not be able to acquire real estate unless they establish residence or have long-term employment in the Czech Republic.

The sector of privately owned housing accounts for approximately 47% of housing stock. Home ownership is developing in a more dynamic manner than other sectors. Development of home ownership is supported by the state and includes construction of new housing, transfers of cooperative housing to private owners, and privatization of municipal housing by sale to existing tenants. Taking into account the income of most households, acquisition of a privately owned dwelling is very costly; however, due to the unresolved situation in the rental sector, even individuals with average and lower income are being forced to use this option. The objective of the government's support for home ownership is to improve its financial accessibility to potential users. The basic instrument of support are income tax deductions. Direct assistance consisting of interest subsidies and state soft loans is currently available to people below 36 years of age.

The existing cooperative sector, which mostly consists of buildings owned by former construction cooperatives, accounts for some 17% of housing stock and in the vast majority of cases functions with no considerable problems. Taking into account the legal ramifications of transferring membership right and duties, membership in a housing cooperative is very similar to home ownership. At present, construction of cooperative housing is very low. Nonetheless, the government has approved a law based on which construction of cooperative housing will be stimulated through subsidies and low-interest loans starting in 2005.

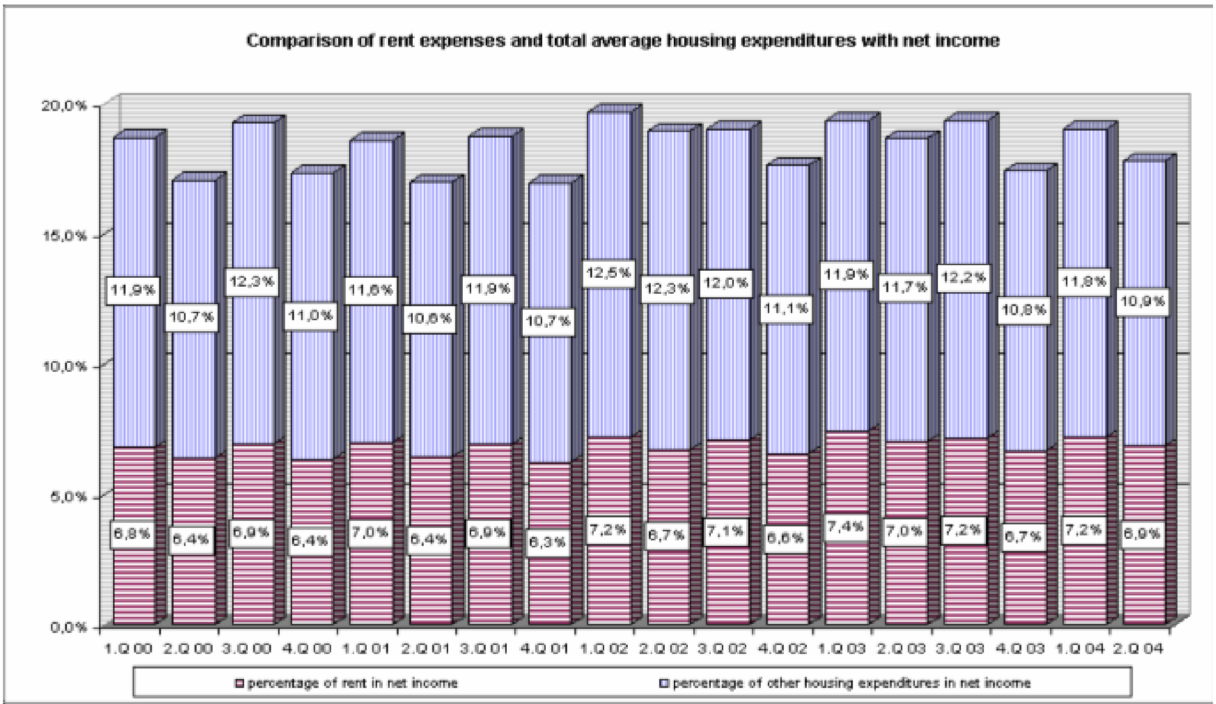
The sector which consists of privately owned rental housing accounts for only about 12% of housing stock. Its functioning is negatively affected by rent control measures and civil-law provisions pertaining to lease of dwellings. Save for exceptions, no construction is taking place in this sector, mostly because tenants enjoy strong legal protection and potential developers see greater opportunities in building privately owned dwellings where the return on invested funds is much faster. In the future, this sector is expected to provide housing mainly for people seeking a short-term solution to their housing situation or those who require high-quality accommodation with matching services. The functioning of this model will depend mainly on the selected rental policies. But, no law on rent regulation has been approved by the Parliament yet.

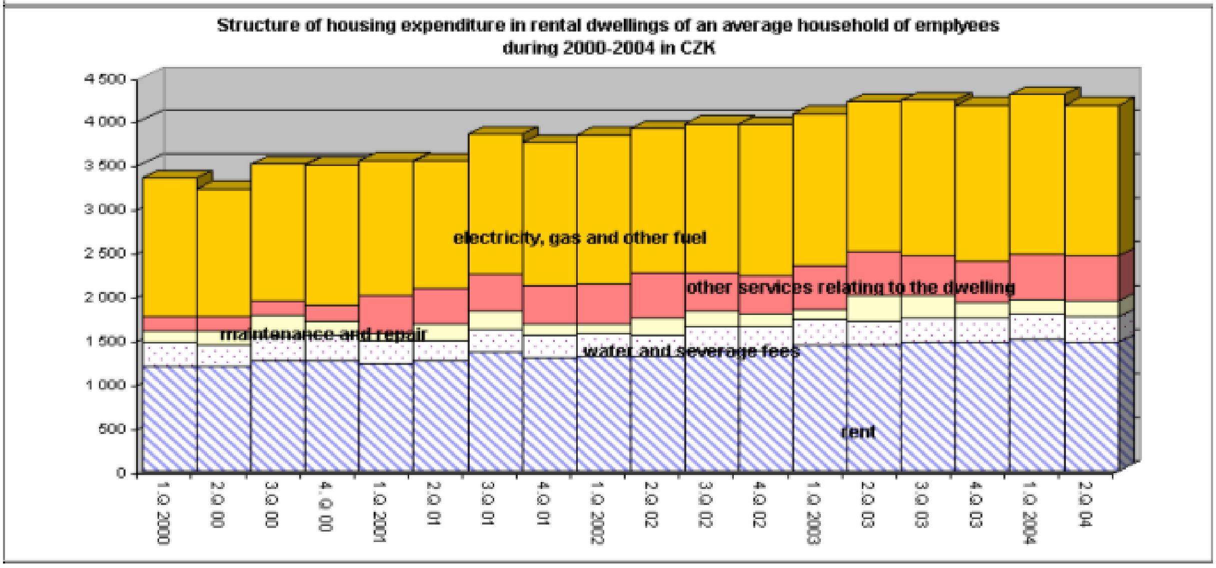
The sector of municipal rental housing accounts for some 17% of the housing market. Like in the preceding case, its functioning is also negatively affected by rent control measures and civil-law provisions pertaining to lease of dwellings. The role of this sector is unclear; depending on the strategy of individual municipalities and their rental policies, municipal housing is used for both social and entirely commercial purposes. Future development of this sector will depend on the selected rental policy and the success of creating a non-profit rental sector.

Matching the supply and demand on the housing market is one of the fundamental objectives of the housing policy. The increasing of supply is stimulated especially through subsidies for construction of rental housing offered to municipalities. In like manner, measures supporting repair and modernization of housing stock contribute to the increasing of supply of dwellings. As to demand, support includes mainly targeted social allowance, subsidized interest on mortgage loans, low-interest loans for acquisition of a privately-owned dwelling, and income tax deductions relating to the use of mortgage loans and similar financing methods.

State housing support (in million CZK)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
	Reality	Reality	Reality	Reality	Reality	Reality	Reality	Reality	Approved budget
Subsidies for repair of housing stock (defects of prefab panel buildings)	123	240	240	420	533	218,5	283,5	286,599	220
Regeneration of panel building settlements	x	x	x	x	x	150	79,8	0	100
Subsidies for construction of new rental housing and technical infrastructure owened by municipalities	2 180	2 698	2 891	3 381	2 884	2 011	542,2	795,181	784,604
Subsidies for construction of supported housing	x	x	x	x	x	x	x	x	190
Subsidies to municipalities for repair and renovation of housing stock	275	240	300	300	300	0	0	0	0
Subsidies for construction of buildings with social services	700	600	670	471	578	575,7	584,2	46	0
Subsidies for replacement of lead plumbing	x	x	x	x	x	x	x	x	12,456
Aid for elimination of damage caused by floods, incl. hailstorm in 1999	x	1 207	368	227	27	0	1 532,9	1 609,337	0
from which subsidies to housing stock							35,2	53,640	
Interest-free government loan	x	270	796	1 450	329	0	0	0	0
Subsidies for mortgage loans	1	34	132	201	307	432,5	517,8	563,250	430
Ministry for Regional Development - total	**3 279**	**5 289**	**5 397**	**6 450**	**4 958**	**3 387,7**	**3 540,3**	**3 300,367**	**1 737,060**
SHDF - Rental housing and technical infrastructure	x	x	x	x	*761*	*3 000*		3 468	1493
SHDF - Construction of rented housing with community care services	x	x	x	x	*0*	*960*			
SHDF - construction of rental housing and rental housing with community care services for municipalities caused by floods								105,5	
SHDF - Program PANEL - Support to repairs of apartment buildings built by prefabricated slab technology	x	x	x	x				57,5	600
SHDF - Credits to municipalities and citizen on construction or acquisition of flats	x	x	x	x				225	600
SHDF - Credits to municipalities for repairing and modernization of flats	x	x	x	x				323	400
SHDF - other	x	x	x	x	*0*	*125*		24,2	170
State Housing Development Fund - total	**x**	**x**	**x**	**x**	**761**	**4 085**	**3 358,6**	**4 203,2**	**3 263**
Construction savings plans subsidies	2 309	3 817	5 068	6 393	7 719	9 313	11 059	13 261	15 200
Financing of comprehensive housing construction	50	35	x	x	x	x	x	x	x
Subsidies for housing construction by individuals and cooperatives	50	x	x	x	x	x	x	x	x
Material damage to banks	2 473	4 800	3 553	1 411	1 414	1 630	1 143	737	684
Ministry of Finance - total	**4 882**	**8 652**	**8 621**	**7 804**	**9 133**	**10 943**	**12 202**	**13 998**	**15 884**
Housing allowance	677	813	1 367	2 084	2 518	2 698	3 028	2 835	
Separate benefits:									
Heat subsidy (paid from 1 July 1997 to 30 June 2000)	x	67	277	236	106	0	0	0	
Rental subsidy (paid from 1 July 1997 to 31 December 2000)	x	49	163	127	73	6	0	0	
Social allowances earmarked for housing **Ministry of Labor and Social Affairs - total**	**677**	**929**	**1 807**	**2 447**	**2 697**	**2 704**	**3 028**	**2 835**	
MRD+SHDF+MF+MLSA	**8 838**	**14 870**	**15 825**	**16 701**	**17 549**	**21 120**	**22 129**	**24 337**	**20 884**
GDP (CZK billion), in 2004 - forecast	.	.	1 962,5	2 041,4	2 150,1	2 315,3	2 414,7	2 532,4	2 707
Percentage of GDP (in %)			**0,81**	**0,82**	**0,82**	**0,91**	**0,92**	**0,96**	**0,77**





5. Future Development

Up to now, low inflation has been the main reason for low interest rates. Any increases of interest rates will depend chiefly on how economic problems are dealt with by foreign countries, the expected renewal of economic growth, and development of the inflation rate.

The prices of domestic real estate are expected to decline since the expectation factor ceased to exist after the Czech Republic joined the European Union. In the subsequent period, real estate prices are expected to stabilize; however, regional differences will become more pronounced.

It can be expected that developments relating to prices (increased VAT rate, real estate prices, possibly elimination of rent control) will result in higher housing-related expenditures paid by households. However, the impact of joining the European Union on housing is lessened thanks to temporary exemptions negotiated by the Czech government which allow applying the reduced VAT rate on housing construction and restricting acquisition of real estate for secondary residential purposes by foreigners.

The anticipated development of the unemployment rate (approximately 10%) stems from economic pressures to increase work productivity which are likely to result in layoffs of workers who do not meet growing qualification demands.

There will be a further increase of the differences between people's income which is relatively low at present in comparison with Western European countries. This trend—which will be the result of an increasing number of jobs in positions with high qualification requirements and social allowances which will increase at a slower rate than earnings—will accelerate the process of social differentiation in the area of housing. As a result, disadvantaged groups of people may be driven outside the scope of the supporting instruments of the housing policy, a trend that will be accompanied by the deepening of their social and spatial segregation.

Although the Czech Republic does not have a shortage of housing on a national scale, the situation in individual regions and municipalities differs considerably. In general, in regions and municipalities where a sufficient number of employment opportunities exist, the demand for housing exceeds supply. The result is a higher cost of housing, which is inaccessible for lower-income households. Meeting the housing needs of such households is difficult. This situation exists especially in Prague, other large cities, and their vicinity, i.e. localities which offer ample employment opportunities. The opposite situation can be found in northern parts of the country which suffer from high unemployment due to structural changes. Demand for housing and housing prices are very low in such localities. This situation shows that there is a disparity between the availability of employment opportunities on the labour market and supply of housing.

In the mid-term, the current trends are expected to intensify, i.e. the differences in the income and housing needs of various groups of the population will continue to increase. The disparity between regions and individual municipalities will most likely gradually deepen, a trend that may be slowed down or stopped by a policy targeting development of affected regions, in particular measures aimed at increasing employment.

During the transitional period following the Czech Republic's accession to the European Union, which has been negotiated to last until 2007, housing-related construction work will remain subject to the reduced value added tax rate (at present 5%). As a result, construction of new housing as well as repair and modernization of housing stock will be less expensive then construction of commercial or production facilities. The fact that the reduced VAT rate will continue to apply to housing construction for a temporary period was therefore mainly due to social reasons, since increasing the value added tax would cause a sharp escalation of the cost of construction of new housing, reducing the accessibility of new and repairs of existing housing stock. During the transitional period, the real household income is expected to grow as a result of economic recovery thanks to which increasing the VAT after the end of the transitional period should not have an overly negative social impact. Nonetheless, construction work relating to social housing will continue to be subject to the reduced VAT rate even after the end of the transitional period.

As the economy grows, real incomes are expected to increase and the accessibility of housing will improve. Some of the negative consequences of the existing forms of rent control include an impossible-to-meet demand for rental housing in "regulated dwellings" which is due to the low amount of regulated rent and disproportionately high rents in dwellings released from rent control. In some Czech cities, contractual rent is several times higher than rent subject to regulatory measures is.

The unsurprising result of this "shortage" of housing is a large black market which will be eliminated only after the price deformations are gradually rectified. The situation concerning uneven rents has an overall negative impact on distribution of housing. Due to the facts described above, the correlation between household income and the housing type has been weakened. As a result, municipal housing stock, which is leased for regulated rent in most cases, is occupied by people from all income brackets, as opposed to being rented to low- and middle-income households, a practice which is customary in European Union Member States. Different prices in the rental sector provide ample space for black market activities which concern several thousands rental dwellings where tenants who pay regulated rent sublet their dwellings illicitly to other people—especially young families—depriving the government of several billion Czech crowns every year. Only after the deformations are rectified and the presently artificially divided rental market is unified, it will be possible to develop additional instruments of support, similar to those used by governments of advanced countries to control the situation in the housing sector. This applies especially to support for housing forms of social nature.

NOTES

1 Source: Ministry of Finance

2 Also effect of way of making surveys, which is however difficult to quantify, could be discussed as a contribution to fall in employment, especially after EU accession. Labour Force Survey covers only persons living in selected flats, i.e. does not cover collective lodging facilities. As a result, many foreign nationals legally working in the Czech Republic may not be included.

3 Over 2004, the Ministry of Labour and Social Affairs introduced a new methodology of calculation of registered unemployment rate. The forecast is based on time series under the original approach. New way of calculation does not change the economic substance of phenomenon or system of welfare benefit granting and as such will have no fundamental impact on the social transfer bill implied by the forecast of unemployment.

4 Statistics of the household sector was similarly as data on economic output influenced by harmonization of quarterly data with preliminary national accounts for 2003. The revision resulted in an increase of growth rate of nominal disposable income from 3.1% to 3.4%, household consumption from 4.2% to 5.1%, and lowering of savings rate from 9.0% to 8.5%. In first-half data for 2004, cuts in pace of growth of disposable income by some 1.5 p.p. (especially in the wage bill) with maintained dynamics of consumption also resulted in savings rate cut.

5 Based on the CSO demographic projection from late 2003.

6 The CNB harmonized the methodology of monitoring long-term interest rates so as to correspond to their reporting when meeting the respective Maastricht criterion.

7 Since January 2004, the CNB introduced a new methodology of monitoring the harmonized interest rates of monetary financial institutions against the clients under the ECB’s binding instruction. A retrospective reconstruction of some data starts with January 2001. For the needs of analysis and follow-up forecast of client interest rates form the total volume of credits and deposits of non-financial sectors, our own calculation based on the CNB data was made. That’s why an interruption can be seen in the following tables and graphs indicating the change in methodology.

8 Source: Martin Lux, Institute of Sociology of the Academy of Science, 2004

CHAPTER 4. HOUSING FINANCE IN SLOVAK REPUBLIC

by

Dana Rigaszova*

1. Macroeconomic Environment

The Gross Domestic Product development continued to gradually accelerate with the Slovak economy's efficiency, albeit with minimal modifications on its supply side. The basic branch structure of the Gross Domestic Product formation has not substantially changed in comparison with the previous year, although a long-term development tendency of market services strengthening at the expense of industry has remained on the same level. On the side of use the acceleration of economic growth was a result of an increased domestic demand.

A positive factor of the Slovak economic development in 2003 was the employment growth mainly influenced by market services. The situation on the labour market was complicated by a relatively high population growth at the productive age – it did not result in the unemployment decrease although there were more job opportunities in comparison with the previous year. The nominal wages growth dynamism accelerated in 2003 which - while the inflation was declining - reflected in a repeated growth of real wages after two years.

Gross Domestic Product in current prices in first half of 2004 was 636.6 mld. Sk, in fixed prices year 1995 399.4 mld. Skk, index / fixed prices year 1995 –105.4%.

2. Tasks of the State defined by the State Housing Policy Concept and Their Implementation

As a result of social conditions in 1989 there were substantial changes in the area of the housing policy. There was actually a total attenuation in the housing construction as a consequence of the fact that the state stopped supporting the housing construction financing. To stop this unfavourable development the Government of the Slovak Republic adopted in 2000 the „Concept of the state housing policy till 2005 with a perspective to 2010". These concepts determine the position of the citizen, municipalities and state in the area of housing provision. Within the market economy the responsibility for the provision of own housing is delegated to the citizen. The state and municipalities are to create suitable conditions for housing provision for citizens.

The provision of the territorial and planning preparation, provision of availability of building plots for housing construction, coordination and participation in housing development and connected technical infrastructure as well as the provision of housing conditions for socially dependent population groups also belong to the tasks of municipalities.

The task of the state is in particular to regulate economic tools to support the housing development and to gradually regulate the particular law in order to eliminate the existing development barriers,

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unsystematically acting regulations and to continuously bring the legislation into compliance with the EU law.

The system of economic tools for the support of the housing development anchored in the legislation is being gradually created. These tools helped to revive the housing construction but so far the requirements of the population in the area of housing construction have not been met. After the initial start in 1996 - 1998 there was an attenuation of the housing construction in 1999 and 2000 as a result of a lack of available funds and the economic situation in the Slovak Republic as well. This decline then reflected with a shift of two years in the decrease of finished flats in 2001. The available data confirm that since 2001 the dynamism of flats being started and finished has repeatedly increased.

In the first half of 2004, 9.077 flats were started and 5.415 flats finished. As part of this are private houses started 5 025 and finished 3 646. 43 649 flats were in building. With compassion to the same time of last year the number of started flats is higher about 51.9 %, finished about 14.7% and in build procedure about 7.1 %.

At time of the census of population, houses and flats to 26 May 2001 the Slovak Republic had 5.379.455 inhabitants and 1.665.536 permanently inhabited flats. This means that according to the census there were 309.6 permanently inhabited flats per 1,000 inhabitants in the Slovak Republic.

According to the census of population, houses and flats to 26 May 2001 the average total flat area was 83.9 m^2 and the average residential flat area 56.1 m^2. The average total flat area per 1 inhabitant was 26 m^2 and the average residential flat area 17.5 m^2. In 2001 within the finished flats the average floor flat area reached approximately 142 m^2 and the average residential flat area ca 86.2 m^2. This development is a result of a high share of flats being started in houses.

Flat provisions per 1.000 inhabitants in the Slovak Republic are comparable with the level in the transition countries but they are significantly behind the developed countries of the Western Europe where this indicator in 2001 was 2.59 inhabitants per 1 flat.

At present it is possible to assume that in the Slovak Republic there is a lack of 255,000 flats and thus legislative and economic conditions need to be established in order to gradually extend the scope of flats being finished and to finish 5 to 6 flats per 1,000 inhabitants in the Slovak Republic in the horizon about 2010.

3. Privatization in the Housing Sector and Ownership Relations

According to the census of population, houses and flats in 2001, of the total number of the permanently inhabited flats there were 820,042 flats in houses (49.2 %) and 845.494 flats in blocks of flats (50.8 %). The housing cooperatives possessed 247,977 flats (29.3 %) and citizens possessed 442,387 (52.3 %) of the total number of flats in blocks of flats (apartment houses) and the remaining part was represented in particular by municipal and state flats.

4. Social Housing Policy

The social housing policy is reflected in the following two areas:

- State support in the housing stock use,
- State support in the housing construction development.

Within the first area the Act on housing bonus was adopted which at present still corresponds to the centralist approach of the state economy management and financing. For the following period in the connection to the public administration reform and decentralization of powers to the regional self-government authorities it will be necessary to amend the act to bring it in compliance with the system usually implemented with EU directives.

Within the area of state support in the housing construction development some support tools were adopted which are focused on all population groups regardless of their income. However, within the social housing policy there were only limited possibilities to get a flat for population groups with lower income, in particular for young families. The housing construction in this area is carried out only with the substantial participation of state subsidies. The actually stopped the construction of rental flats caused by a strict deregulation of rent represented a permanent economic loss for the owners of rental flat stock. This deformation was eliminated on 1 February 2001. For these reasons it was possible neither to develop the construction of special housing forms (in particular the first housing for young people, the so called start-up flats), housing for older citizens in custody service homes, nor the flats of a lower standard for citizens who do not pay rent and for inadaptable citizens.

To create more appropriate conditions for the housing construction support for citizens with low income further laws have been recently adopted creating a scope for the regulation of this area; it is in detail described in the next part of this material.

5. Housing Construction Financing

Economic systems were gradually created and improved to finance the housing construction. Simultaneously with these systems the state supported the rental flats construction and flat technical infrastructure by its direct subsidies. As it follows from the previous part the state is gradually taking further measures which directly or indirectly support the housing construction.

From the point of view of the housing construction financing the state support can be divided into two areas:

1. A direct support area

2. An indirect support area.

5.1. Direct Support Area

The direct support can be further divided into:

1. Housing construction financing systems

   - Housing savings

   - Mortgage loans

   - State Housing Development Fund (hereinafter referred to as „SHDF“)

2. Housing construction financing support programs

   - Subsidy programs

- Bank guarantees program

5.1.1. Housing Construction Financing Systems

Housing savings

The area of housing savings in the Slovak Republic is regulated by the Act on housing savings. The keystone of the housing savings is the collection of financial means in the housing savings fund by clients of housing savings banks and their usage for the needs of housing construction via housing loans. The housing savings in the Slovak Republic is a closed system independent of the development on the money and capital markets.

Housing savings banks operating in the Slovak Republic

Name	Operation since
Prvá stavebná sporiteľňa, a. s.	1992
VÚB Wüstenrot, a. s.	1993
ČSOB stavebná sporiteľňa, a. s.	2000

The housing savings fund consists of deposits of housing savings clients (hereinafter referred to as "housing saver"), interest on deposits, state budget contributions (hereinafter referred to as "government bonus"), repayments of credits already extended and other sources.

The housing savings may be carried out only by a bank established as a joint stock company which was given a license to operate as a bank and if the operation of this bank lies in housing savings (hereinafter referred to as "housing savings bank"). Beside the main operation, which consists of accepting the deposits from housing savers and extending housing loans to its clients, a housing savings bank may provide guarantees to another bank for housing loans, mortgage credits or municipal credits, it may accept deposits from banks, make deals for own account with mortgage bonds, municipal bonds, government bonds including government treasury bills or treasury bills of the National Bank of Slovakia, and provide consulting services connected with housing savings. Interest is paid on deposits of housing savers.

According to legal regulations in effect a housing saver may be a natural person (individual) with a permanent residence within the territory of the Slovak Republic who concludes a housing savings contract with a housing savings bank or in favour of whom a housing savings contract is concluded, a legal person (corporate body) with a place of business within the territory of the Slovak Republic or a natural person – entrepreneur with a permanent residence within the territory of the Slovak Republic who concludes a housing savings contract with a housing savings bank.

The housing savings starts by concluding a contract between a housing saver and housing savings bank on a contractually agreed target amount. This amount consists of deposits from a housing saver, interest, government bonus, housing loan and other sources. After meeting the contractually agreed conditions a housing saver is entitled to get a housing loan. A housing saver may set up a claim for a housing loan, withdraw his deposit and use it without a claim for a housing loan or keep on saving.

A housing saver gets a housing loan if he/she meets the contractually agreed conditions and terms of housing savings (amount of saved sum, saving period) and if he/she meets the conditions of economic return of the housing loan. The amount of a housing loan is equal to the difference between a target amount and saver´s deposits, including interest, government bonuses and other sources.

The government bonus as a support of state in this area makes 15 % of the annual deposit of a housing saver but not more than an amount determined by the Act on state budget for the particular budget year. For this year the Act on state budget determines the maximum amount of the government bonus per 1 housing saver to the amount of 83,-USD. The provision of the government bonus to a housing loan and housing policy has the intention to establish conditions for collecting available long-term financial means of population from which long-term credits with lower interest rates could be granted. The amount of the government bonus in the Czech Republic and Croatia is 25 %, in Germany 10 % and in Austria 4.5 %. However, in the late 60´s the government bonus in these two countries was yet higher than 30 %.

The government bonus is yearly provided to a housing-saver – natural person only upon one housing savings contract during the period of savings. In the case, when a housing-saver has concluded more housing savings contracts, the government bonus may be provided only upon one of them.

A housing-saver may use the target amount, if a part of it also consists of a granted housing loan, for financing housing needs in the Slovak Republic. A concrete possibility of disposal of funds acquired from housing savings is the acquisition of the ownership of a flat, house or block of flats (apartment block), the construction, extension, superstructure, in-building or modification of a house or block of flats or modification of a flat, modernisation and maintenance of a flat, block of flats or house, acquisition of the ownership of a building plot for the purposes of the construction of a house or block of flats, acquisition of the ownership of a plot on which a house or block of flats is already located, acquisition of the ownership of non-dwelling spaces in a block of flats for the purpose of the conversion of non-dwelling spaces into a flat, conversion of non-dwelling spaces into a flat, the payment of the share to a housing co-operative for the purpose of acquisition of a flat, and payment of the commitments (liabilities) related to the above mentioned purposes.

As the consequence of an increase of the state budget deficit, the Slovak Republic is currently forced to implement measures to stabilize the budget income and expenditure. Such changes are likely not to avoid also the field of housing savings where the Ministry of Finance of the Slovak Republic has prepared a draft amendment on housing savings in order to change procedures of providing the government bonus with calculation through the special formula. The above-mentioned draft has been approved by the government and submitted to the National Council of the Slovak Republic with proposed effection on January 1, 2004...

In advanced economies (Germany, Austria, France, U.S.A) with long-term experience of the housing savings the impact of this system on the overall economy is rated and may be summarised as follows: Additional savings reduce the consumption what has the beneficial effect on prices (inflation rate); continuous cumulation of long-term savings and linked granting of housing loans has the strong stabilisation impact on the economy as a whole (*en bloc*); the state supports the transformation of the short-term savings to the long-term savings and investments through the government bonus; the housing savings system creates the housing demand relatively independently from the development of the market interest rates and cyclical motions; housing loans have the beneficial effect on the construction industry and related industries of the economy; the private housing construction creates a relatively large number of jobs compared to other industries of economy; the housing construction sector employs all goods (commodities) dedicated for housing what favourably impacts on the economic growth.

Mortgage loans

In the Slovak Republic, the mortgage banking is provided by the Act number 483/2001 Collection of laws on Banks. Commercial banks with a licence to transact mortgage business may grant mortgage loans (to issue mortgage backed bonds) and may grant municipal loans (issue municipal bonds).

Banks with the licence to transact mortgage business

BANKS	DATE OF GRANTING THE NCE	DATE OF THE START OF ACTIVITIES
Všeobecná úverová banka	Jun1997	October 1997
DEXIA bank	December 2002	November 2003
Slovenská sporiteľňa	December 1997	July 1999
Istrobanka	November 1998	3rd quarter of 1999
Tatrabanka	January 2000	October 2000
HVB bank	October 2000	merger with HypoVer.
ČSOB	November 2001	April 2002
Unibanka	May 2002	July 2002
OTP Banka	August 2002	January 2003
Ľudová banka	October 2002	January 2003

The mortgage loan is a loan with maturity of at least four years and maximum thirty years, secured by the right of lien established upon domestic real estate. The mortgage loan may be used for the acquisition of domestic real estate or its part, construction or modification of completed structures, maintenance of domestic real estate, or repayment of a granted loan (that is not a mortgage loan) used for the above-mentioned purposes.

The municipal loan is a loan with maturity of at least four years and maximum thirty years, secured by the right of lien established upon real estate owned by a municipality or real estate owned by a regional territorial unit (VÚC). Banks grant this kind of the loan for the acquisition of domestic real estate, construction, modification of completed structures, and maintenance of domestic real estate and other structures in order to use them for public service purposes.

In year of 2003 were average interest rates of mortgage banks in Slovakia from 7 to 9 % without the state contribution.

The National Bank of Slovakia appoints a mortgage controller to each mortgage bank, to supervise the conduct of mortgage transactions in the scope provided by the At on Banks and Act on Bonds.

The state aid in the field of the mortgage banking is implemented through the provision of a government bonus to a mortgagor who is a natural person. The government bonus is a percentage by which the rate of interest set in a mortgage loan contract is reduced by the Government. The percentage amount of the government bonus may not be changed over the entire maturity of the mortgage loan set in the mortgage loan contract. The percentage amount of the government bonus for contracts concluded in individual calendar years is laid down in the State Budget Act for the respective fiscal year. In 2002 the government bonus is set out for 4.5% (in 1999 – 2000 it was 6 %, in 2001 – 5 %, in 2002-4.5%, 2003-2.5%, 2004-1%). In 2005 government bonus is 0%.The government bonus is granted only upon one mortgage loan contract, from the amount of a mortgage loan not exceeding 2.5 mil. Skk per one housing unit.

The development of mortgage and municipal banking you can see in next table.

Development of mortgage business loans

Year	1999	2000	2001	2002	2003	2004
The amount of mortgage loan /in mil.SK /	570	1,446	3,903	9,250	18,938	15,000
Impact on state budget /amount of state contribution in mil.Sk /	80	100	127	226	490	775

State Housing Development Fund

The State Housing Development Fund was established by the law governing its position and conditions of granting the government aid in order to extend and enhance the housing stock. Subsidies from the State Housing Development Fund (hereinafter referred to as "SHDF") in the form of an advantageous long-term loan and non-recurring bonus are granted for the construction of a flat in a block of flats or house, if appropriate, construction of social service facilities, thermal protection of a block of flats or house, if appropriate, modification of a completed structure of a block of flats or house, remedy of static defects of a block of flats and for the purchase of a new structure of a flat.

Overview of SHDF expenditures granted for the extension and enhancement of the housing stock

MILL. USD								
Indicator	1996	1997	1998	1999	2000	2001	2002	2003
Subsidies for the extension and enhancement of the housing stock	8,0	39,0	82,1	38,3	79,3	85,7	287	374
of that: - loans	7,8	32,0	65,1	29,7	68,6	85,1	514	290,1
- non-recurring bonus	0,3	7,1	17,2	8,6	10,6	0,6	10	44,3

In 2003 the SHDF had concluded 3,967 contracts with private persons, and the subsidies in the total amount of 2,603 mill. Skk were granted, thereof 2,599 mill. Skk in the form of a loan and 3,826 mil. Skk in the form of non-recurring bonus. The provision of subsidies was mainly focused on the construction of flats, and it may be observed that the construction of new 3 903 flats, and re-new 64 flats was supported through the SHDF.

By January 1, 2004 is in effection new amendment of Act on SHDF.

5.1.2. Supporting Programmes of Housing Construction Finance

Subvention Programmes of Housing Construction Finance

In addition to the subsidies provided through systems of financing housing construction, the state aid connected to housing construction is manifested by the annual allocation of subsidies from the state budget and funds gained in the privatisation process for the provision of facilities construction, acquisition of rental flats for residents with low income and remedy of damages of block of flats built using the panel technology, which are not caused by the insufficient maintenance.

Therefore, effective from 1st January 2004, a new model has been implemented, which brings the financial sources of commercial banks in this field. Finance for the acquisition of rental flats under the public rental sector is currently supported by government subsidies allocated for the partial payment of acquisition costs of a flat and partial payment of the interest rate from a loan granted for the acquisition of a flat, by a loan from the commercial banks and investor's own sources.

Yearly state expenditure to housing

YEAR	2000	2001	2002	2003	2004
Funds of state budget in mil.Sk	6,283	7,333	7,667	6,904	7,120
% as share from yearly state budget	2.6	2.9	2.8	2.8	2.5

Program of Bank Guarantees

The program supporting the housing construction development, implemented in the form of the provision of bank guarantees for loans assigned to housing construction, which was approved by the SR Government in 1999, has laid down conditions for using private funds in the field of housing. The aid to legal persons in the form of liability for a loan assigned to the field of housing construction and remedy, modernisation and reconstruction of the housing stock may be granted through this programme. The priority under this programme is given to guarantees for loans assigned to rental housing construction for socially disadvantaged groups of inhabitants. The provision of such form of the state aid is implemented in accordance with the State Aid Act, which is compatible with EU directives.

No amount has been allocated from the state budget in order to implement this programme by Slovak guarantee and development bank this year.

5.2. Field of Indirect Support

The field of indirect government support within housing construction, which is formed by tax relief and tax incentives, lags far behind measures in the field of direct support, adopted under the concept of the government housing policy.

Within the fiscal policy, the partial measures regarding the tax exemption have been implemented:

- exemption from tax on real estate: flats, houses and block of flats for the period of 5 to 10 years (from 1st January 1993)
- exemption of housing cooperatives from the tax on income derived from rental of cooperative flats, garages and payments provided in the connection with their usage (from 1st January 1993)
- exemption from tax on income of individuals (natural persons): interests from deposits under housing savings (from 1st January 1994),
- exemption from tax on income: interest gains from mortgage backed bonds of natural and legal persons (from 1st April 1999)

- the first assignment of the flat ownership in a block of flats or house ownership in a family house from the constructer ownership to the natural person or legal person ownership is exempt from tax (from 1st April 2002).

These measures in the field of fiscal policy have not motivated investors to engage themselves in the housing construction development. For the housing construction development, there is necessary to develop the fiscal tools in order to stimulate investors for the field of housing construction.

6. Tendency in the Field of Housing Construction Finance

In 2001 the Government adopted "The Concept of Housing Development" on the basis of which it is necessary for the effective usage of financial sources to enhance individual systems so that they will not be implemented overall. It is necessary to determine their effects on individual groups of inhabitants depending on the level of their income.

The housing development support using the government economic tools is, in accordance with this Concept, focused on the target solution represented by financing the housing development, mainly from private sources; public finance of the state and municipalities are focused on the housing support of socially disadvantaged groups of inhabitants and on the indirect support in the form of tax relief.

All the systems of housing construction finance created during the previous years, including the investors' own sources, must take part in the financing of housing construction till 2010. Bank sources are more significantly involved in the system, in the form of both the mortgage loans implemented through mortgage backed bonds and standard mortgage loans, and commercial bank loans.

From the participation of individual systems in housing construction finance, adopted under the Concept of Housing development, the proportion of these systems of housing construction finance should be considerably modified, and charts 1 and 2 represent its development.

Chart 1 - Proportion of three existing systems of housing construction finance in 2005

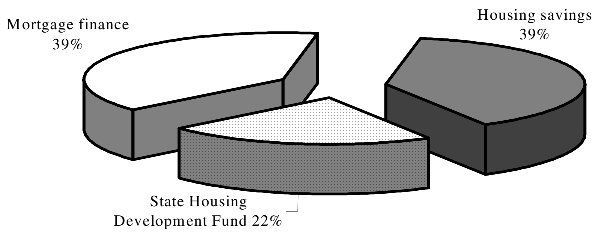


Chart 2 - Assumption for number of new build flats

YEAR	2004	2005	2006	2007	2008	2009	2010	2015	2004-2015
Flats total	16,000	17,000	18,500	20,000	21,000	22,500	24,000	27,000	269,000

Chart 3 - Proportion of three existing systems of housing construction finance in 2010

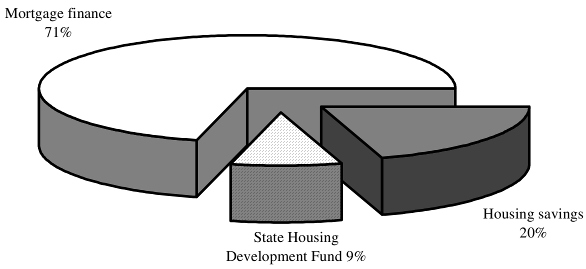


Chart 4 - Asumption for financial needs for construction of new flats

YEAR	2004	2005	2006	2007	2008	2009	2010	2015
Total flats	34,967	39,753	46,289	53,545	60,158	68,967	78,714	124,200

7. Summary

In the near future, in the field of housing construction finance, the economic performance in the Slovak Republic requires from individual participants of this process to continue performing their intents. The field of indirect subsidies, mainly the field of taxation, must be developed in order to develop housing construction. It is necessary to adopt those taxation tools that would motivate investors to invest in housing construction and renovation of the existing housing stock.

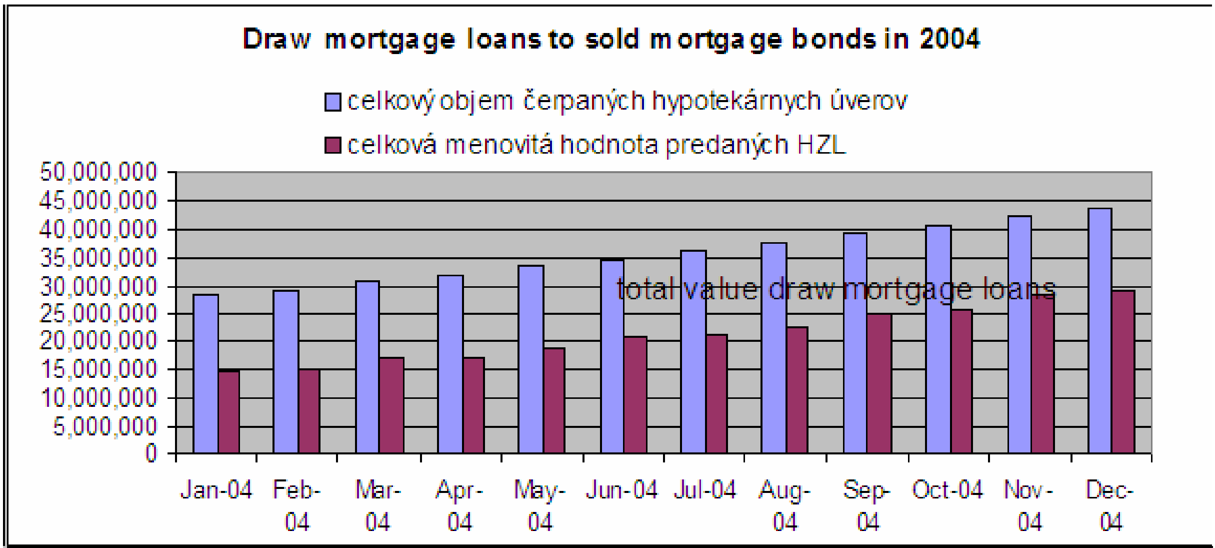
Concerning the situation in the capital and financial markets of the Slovak Republic, the participation of foreign financial institutions in granting available sources for financing mainly the construction of flats in the public rental sector is desirable. This field is step-by-step implemented through the entry of foreign subjects into the banking sector of the Slovak Republic.

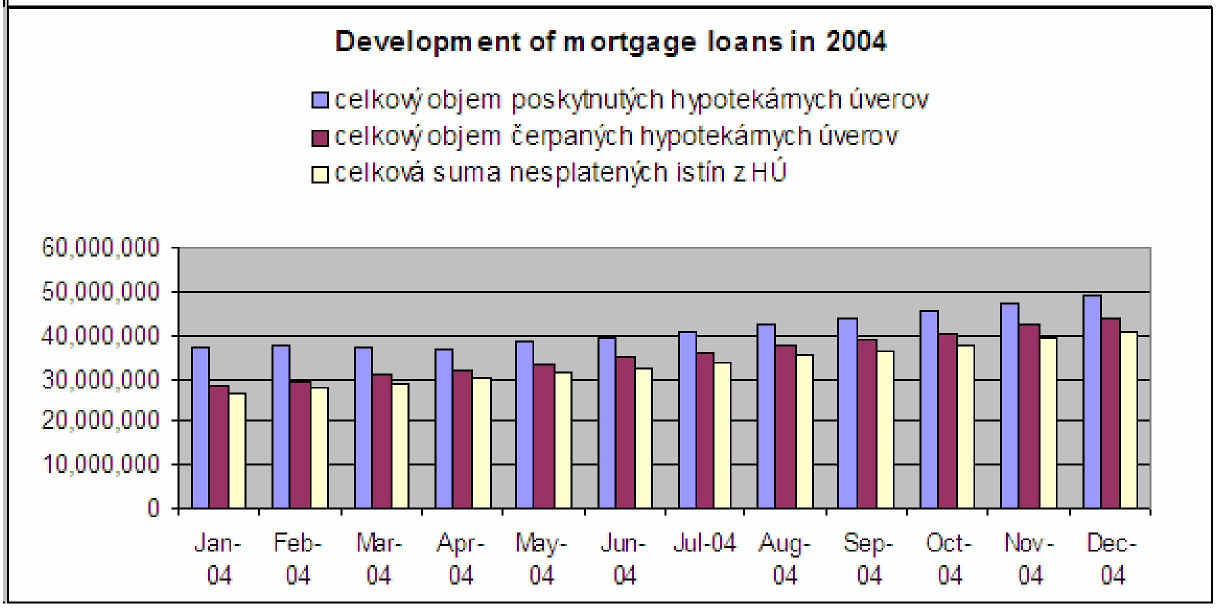
The Slovak Republic actively co-operates with international institutions in order to assure sources. In co-operation with the Council of Europe Development Bank the project of co-financing the construction of municipal rental flats for residents with low income is currently implemented from sources of municipalities and the Council of Europe Development Bank.

It is to be necessary to analyse in details the current amount of the Government subsidy and its efficiency in order to develop the field of housing construction finance and build an effective state aid in this field. Draft regulations laying down principal parameters concerning setting out the government bonus under housing savings and under mortgage loans consider a decrease in the Government subsidy in 2003 by reason of stabilisation of the budgetary field.

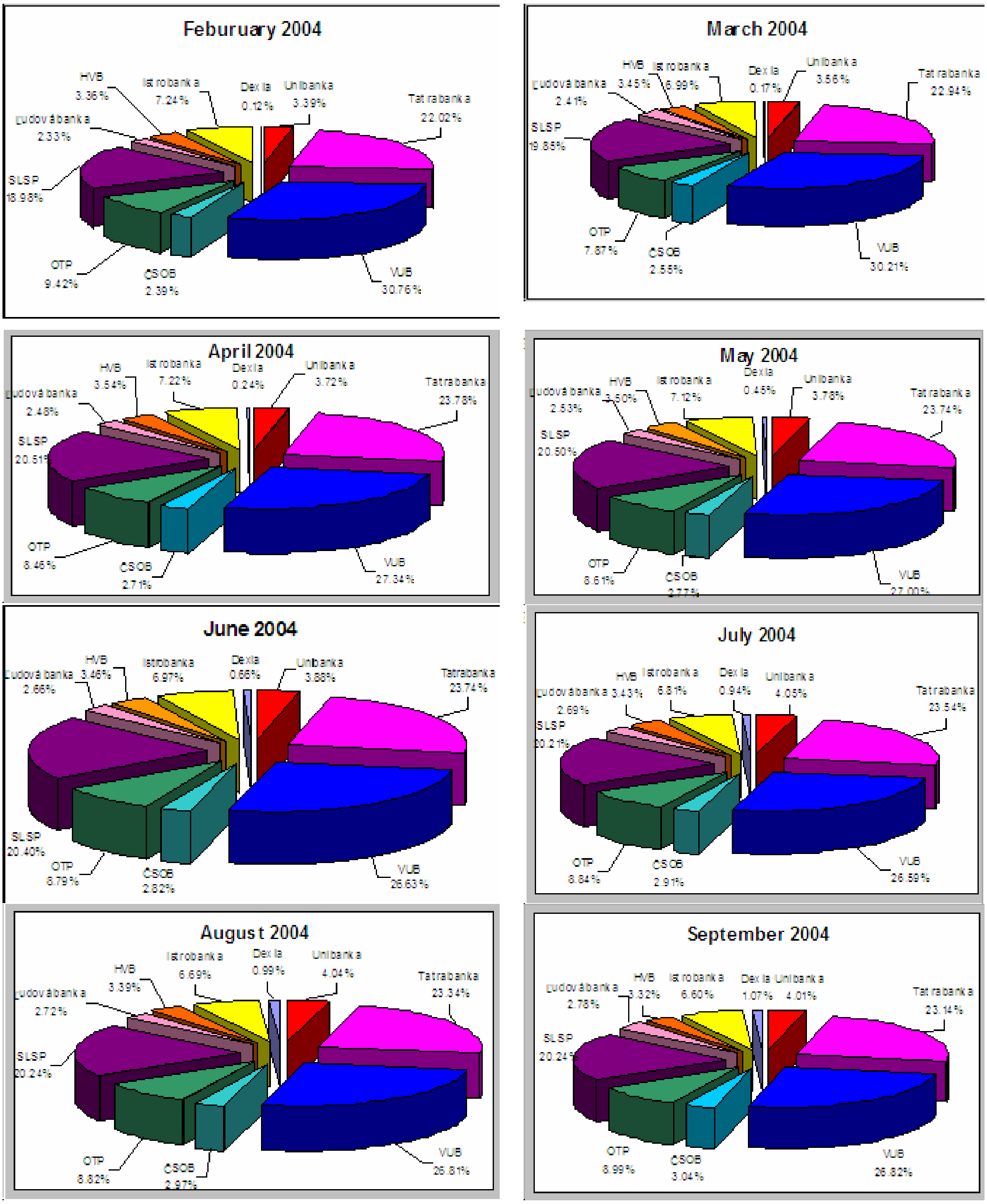
Developments of mortgage loans for banking sector of Slovak republic in 2004

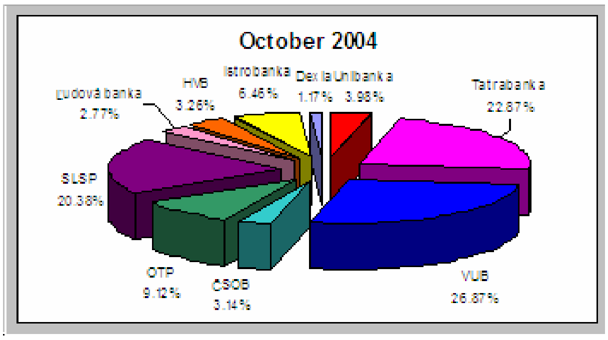
Mortgage loans in thousand of SKK	**31.1.2004**	**29.2.2004**	**31.3.2004**	**30.4.2004**	**31.5.2004**	**30.6.2004**
Total volume of granted mortgage loans	37 147 757	37 732 000	37 184 771	37 054 752	38 250 786	39 559 508
Number of closed contracts	*47 012*	*47 837*	*47 291*	*46 722*	*48 008*	*49 543*
Total volume of draw mortgage loans	28 121 785	29 224 387	30 632 394	31 886 876	33 306 148	34 631 120
Number of closed contracts	*38 561*	*40 000*	*41 571*	*42 991*	*44 157*	*45 605*
Total amount unpaid principals from mortgage loans	26 628 435	27 622 285	28 894 295	30 019 779	31 262 240	32 509 203
Total nominal value issued mortgage bonds	14 742 910	15 142 910	17 585 210	17 585 210	19 084 210	21 085 210
Number of issues of mortgage bonds	26	26	29	29	30	33
Total nominal value of sold mortgage bonds	14 542 910	14 942 910	16 885 210	17 123 010	18 880 810	20 885 210
Ratio of total nominal value of sold mortgage bonds to total amount of unpaid principals from mortgage loans (v %)	54,61	54,10	58,44	57,04	60,39	64,24
Mortgage loans in thousand of SKK	**31.7.2004**	**31.8.2004**	**30.9.2004**	**31.10.2004**	**31.11.2004**	**31.12.2004**
Total volume of granted mortgage loans	41 055 214	42 515 331	43 910 704	45 516 982	47 175 760	48 814 563
Number of closed contracts	*51 170*	*52 770*	*54 225*	*55 806*	*57 406*	*59 103*
Total volume of draw mortgage loans	36 031 329	37 588 237	38 971 696	40 533 683	42 387 240	43 678 074
Number of closed contracts	*47 207*	*48 902*	*50 517*	*52 173*	*53 727*	*55 350*
Total amount unpaid principals from mortgage loans	33 741 981	35 183 321	36 453 114	37 877 697	39 354 465	40 757 284
Total nominal value issued mortgage bonds	21 585 210	22 585 210	25 085 210	25 892 310	28 642 310	30 142 310
Number of issues of mortgage bonds	34	36	39	40	42	44
Total nominal value of sold mortgage bonds	21 385 210	22 385 210	24 885 210	25 692 310	28 442 310	29 158 380
Ratio of total nominal value of sold mortgage bonds to total amount of unpaid principals from mortgage loans (v %)	63,38	63,62	68,27	67,83	72,27	71,54

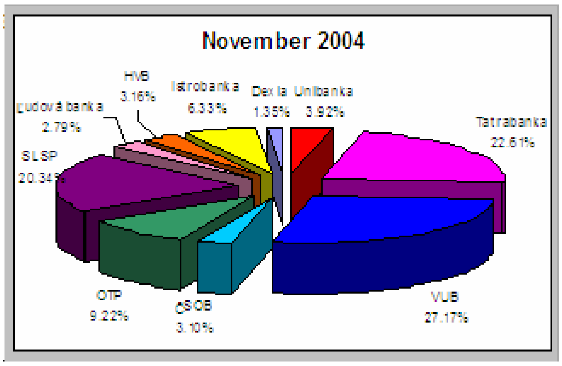

Draw mortgage loans to sold mortgage bonds in 2004
celkový objem čerpaných hypotekárnych úverov
celková menovitá hodnota predaných HZL
total value draw mortgage loans
50,000,000
45,000,000
40,000,000
35,000,000
30,000,000
25,000,000
20,000,000
15,000,000
10,000,000
5,000,000
0
Jan-04
Feb-04
Mar-04
Apr-04
May-04
Jun-04
Jul-04
Aug-04
Sep-04
Oct-04
Nov-04
Dec-04

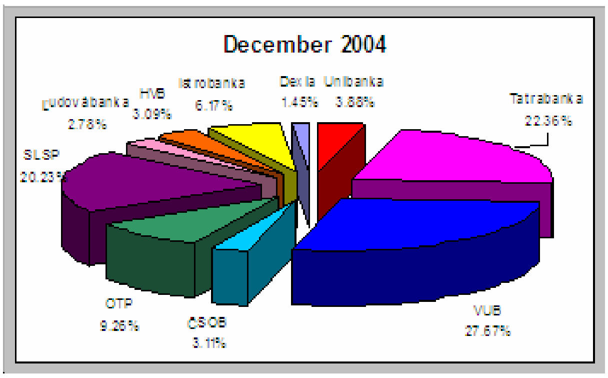

Development of mortgage loans in 2004
celkový objem poskytnutých hypotekárnych úverov
celkový objem čerpaných hypotekárnych úverov
celková suma nesplatených istín z HÚ
60,000,000
50,000,000
40,000,000
30,000,000
20,000,000
10,000,000
0
Jan-04
Feb-04
Mar-04
Apr-04
May-04
Jun-04
Jul-04
Aug-04
Sep-04
Oct-04
Nov-04
Dec-04

Ratio of mortgage banks to total volume of granted mortgage loans




October 2004
Ľudová banka 2.77%
HVB 3.26%
Istrobanka 6.46%
Dexia 1.17%
Unibanka 3.98%
Tatrabanka 22.87%
SLSP 20.38%
OTP 9.12%
ČSOB 3.14%
VUB 26.87%


November 2004
HVB 3.16%
Istrobanka 6.33%
Dexia 1.35%
Unibanka 3.92%
Ľudová banka 2.79%
Tatrabanka 22.61%
SLSP 20.34
OTP 9.22%
ČSOB 3.10%
VUB 27.17%


December 2004
Ľudová banka 2.78%
HVB 3.09%
Istrobanka 6.17%
Dexia 1.45%
Unibanka 3.88%
Tatrabanka 22.36%
SLSP 20.23
OTP 9.26%
ČSOB 3.11%
VUB 27.67%

CHAPTER 5. HOUSING FINANCE IN LITHUANIA *

1. Macroeconomic Characteristics

As it was presented in the Memorandum of Economic Policies of the Government and Bank of Lithuania for the period July 1, 2001-December 31, 2002, during the past eighteen months, Lithuania has made significant progress in restoring macroeconomic stability, following severe disruptions in 1998-99 in the wake of the Russian financial crisis. Decisive steps were undertaken with the support of a stand-by arrangement with the IMF, treated as precautionary, including the reduction of the general government fiscal deficit from 8.5 percent of GDP in 1999 to 2.8 percent in 2000, with a deficit of 1.4 percent of GDP planned for 2001. Exports grew by more than 25 percent in 2000, strongly outpacing the recovery of imports, so that the current account deficit declined from 11.2 percent of GDP in 1999 to 6.0 percent in 2000. Growth resumed in 2000, with real GDP increasing by 3.3 percent, as compared with a decline of 3.9 percent in 1999, and inflation remained subdued, with the average consumer price index (CPI) increasing by 1 percent on an annual basis. All of these positive developments boosted confidence in the Lithuanian economy and its currency board arrangement (CBA), allowing for continued access to international capital markets at increasingly favorable rates. (Table 1)

Table 1: Main economic indicators in 1994-2001

	1994	1995	1996	1997	1998	1999	2000	2001[1)]
Gross domestic product at current prices, mill. litas	16904	24103	31569	38340	42990	42655	45148	47958
as compared to previous year at constant prices of 1995 growth, drop (-),%	-9.8	3.3	4.7	7.3	5.1	-3.9	3.8	5.9
GDP in private sector, %	60	65	68	70	70	70	72	
Population, beginning of year, thous.[2)]	3671.3	3643.0	3615.2	3588.0	3562.3	3536.4	3512.1	3487.0
Natural increase, thous.	-4.1	-4.1	-3.8	-3.3	-3.7	-3.6	-4.8	-8.9
Net migration, thous.[2)]	-22.5	-22.8	-22.4	-21.4	-21.0	-20.3	-20.3	-2.6
Employed, thous.	1675.0	1643.6	1659.0	1669.2	1656.1	1647.5	1586.0	1521.8
in public sector, %	39	36	35	33	32	32	31	30
in private sector, %	61	64	65	67	68	68	69	70
Unemployed, thous.[3)]	65.7	109.0	124.5	104.5	113.7	148.7	204.9	223.5
Unemployment rate, % [3)]	3.8	6.1	7.1	5.9	6.4	8.4	11.5	12.5
Number of unemployed having received unemployment benefit, thous. [3)]	18.2	34.1	35.6	21.9	19.4	24.7	32.3	31.6
Average gross wages and salaries of employees, LTL	325	481	618	778	930	987	971	991

* This paper was prepared by the Housing and Urban Development Foundation (HUDF) for the Third OECD Workshop on Housing Finance in Transition Economies held at Warsaw, Poland on 5-6 December 2002. Due to the administrative reform in Lithuania, the function of HUDF has been merged into the newly established Central Project Management Agency (CPMA) recently.

Indices of real wages and salaries of employees in national economy (previous year = 100)	114.2	103.5	103.3	113.4	112.8	104.9	94.9	100.6
Base earnings, LTL	-	71	85	95	104	105	105	105
Average retirement pension (non-working pensioners), LTL	113	151	192	243	288	310	313	318
Inflation (compared to December of the previous year), %	45.1	35.7	13.1	8.4	2.4	0.3	1.4	2.0
Construction cost indices (previous year = 100)	184.0	125.4	116.8	109.8	105.5	102.2	100.9	99.5
Construction cost indices (December of previous year = 100)	146.6	119.9	112.5	107.7	104.2	99.6	103.0	97.8
Volume of own-account work carried out by construction enterprises and partnerships at current prices, mill. LTL	1754	2209	2282	2860	3489	3262	2641	

[1)] Provisional data. [2)]Data a revised according to provisional results of 6 April 2001 Population Census. 3475.6 thous. population - as of 1 January, 2002.
[3)] Data provided by the National Labour Exchange. © Statistikos departamentas prie Lietuvos Respublikos Vyriausybės Last update: 2002.10.08

Substantial progress was made during 2000 and the first half of 2001 in implementing structural reforms, essential to an efficiently functioning market economy, with the support of a Structural Adjustment Loan (SAL) from the World Bank. Particularly important steps included: an initiation of the pension reform and strengthening of the finances of the state Social Insurance Fund (SoDra); significant fiscal structural reforms, including passage of the Organic Budget Law and steps to set up a Reserve Stabilization Fund (RSF) for the investment of privatization proceeds; important reforms of the Treasury system; a strengthening of the finances of Lithuanian Power (LPC) and Lithuanian Gas (LG) in advance of their future privatization; a rationalization of agricultural subsidies and support programs; passage of new bankruptcy and company restructuring laws, as well as amendments to the labor code to render the labor market more flexible; and a major breakthrough in privatization efforts, with the sale of an additional 25 percent stake in Lithuanian Telecoms via a public offering in June 2000, and of the Savings Bank and the Lithuanian Shipping Company (LISCO) in the first half of 2001 to major foreign investors via competitive tenders. At the same time, trade was liberalized further, with the accession to the WTO ratified in April 2001, while major progress towards European Union (EU) accession was registered.

In spite of this progress, some areas of weakness remain. Registered unemployment increased from 10.0 percent at end-1999 to 12.1 percent in June 2001, and social safety nets need to be reinforced. Further improvements to the business environment and greater labor market flexibility are needed, in order to promote higher rates of growth, domestic and foreign investment, output, and employment creation. In fact, investment slumped from 26.5 percent of GDP in 1997 to just over 20 percent of GDP in 2000, and credit growth was sluggish during much of 2000. Insufficient progress was made in restructuring the electricity and gas sectors, leading to delays in privatization. Expenditure arrears of the central government, which amounted to LTL 440 million at end-1999, were reduced to LTL 19 million by end-March 2001, but not fully eliminated as targeted under the previous stand-by arrangement, while municipal arrears increased. Improvements in health and education are needed, and the finances of municipalities and the Health Insurance Fund (HIF) should be strengthened.

Macroeconomic Outlook

The macroeconomic outlook for 2001-02 envisages a continued recovery of growth, low inflation, and the maintenance of the external current account deficit at a sustainable level. Economic growth is projected to accelerate from about 3.6 percent in 2001 to 4.7 percent in 2002, underpinned by a recovery of domestic demand and continued good export performance. Average inflation is projected at around 1 percent in 2001 and 3 percent in 2002. The external current account deficit is projected to widen slightly to 6.7 percent of GDP in 2001, reflecting the pick-up of domestic demand from 2001, and to start to narrow again in 2002, due to sustained export growth, enhanced productivity, a more business-oriented regulatory environment and a deepening of structural reforms. Foreign direct investment is projected to increase significantly in 2001-02, as several major privatization projects are to be completed during these years. Access to capital markets on favorable terms is expected to continue, and external debt ratios would remain stable.

Over the medium term, macroeconomic policies will aim at boosting real growth rates to about 5-6 percent a year, maintaining inflation at around 2-3 percent, consistent with faster productivity growth than in trading partners, and gradually reducing the external current account deficit to below 6 percent of GDP by 2005. This projected path would be underpinned by further fiscal consolidation, reaching a balanced budget position (excluding the cost of the pension reform) at the time of EU accession, assumed to occur in 2004, as well as further improvement in Lithuania's external competitiveness, brought about by structural reforms. A sizable share of EU-related investment would be financed by EU transfers, and about half of the external current account deficit would be financed by FDI inflows, contributing to a gradual reduction of external indebtedness and a strengthening of Lithuania's external position.

Population

As of 6 April 2001 the population of the Republic of Lithuania totalled 3 483 972 usual resident population, of which 2 332 098 in urban areas and 1 151 874 in rural areas. Specific weight of Lithuanians made up 83.5 per cent; Roman Catholics accounted for 79 per cent of Lithuania's population.

Statistics Lithuania finished processing the 2001 Total Population and Housing Census data, on which basis the database was formed enabling to release final census results. The number and composition of urban and rural population based on the data of the last Population censuses are presented in Table 2.

Table 2: Changes in the Number of Population and its Distribution

Census year	Number of population			Population, %		Population density per sq. km
	total	urban	rural	urban	rural	
1989	3 674 802	2 486 832	1 187 970	67.7	32.3	56.6
2001	3 483 972	2 332 098	1 151 874	66.9	33.1	53.4

The number of population between the Population census conducted in 1989 and that in 2001 contracted by 190.8 thous.: the natural increase from 1989 till 6 April 2001 totalled 33.7 thous. (births accounted for 546.1 thous., deaths made up 512.4 thous.), negative net migration equalled 224.5 thous. The number of Lithuania's population in 1966 exceeded three millions and continued to grow till 1992. Later, due to migration and natural decrease, the number of population started contracting. The number of population as compared with 1989 declined by 5 percent. The specific weight of Lithuania's urban and rural population equalled the level of 1970. The bulk of urban population (68.5 per cent) was observed in 1991. Urban population has displayed a down-warding trend since 1992; while the number rural population has been rising. Comparing the data of the latest Population census with those of 1989 one can see the number of the population falling by 155 thous. and the number of rural population declining by 36 thous. The changes were influenced by the shifted migration directions. The main migration direction "from country to town" showed the different trend: the level of urban population emigrating to foreign countries augmented, while certain share of population moved for living to rural areas. However, the specific weight of urban and rural population remained stable. Over the twelve years the number of population in all biggest cities decreased: the most notable fall was observed in the Kaunas town, the opposite situation was in the Panevezys town (Table 3). However, concentration of urban population in the biggest cities has not shown significant changes: according to the results of the latest censuses, 59 per cent of urban population fell per five biggest cities.

Table 3: The Number of Population in the Biggest Cities

	2001	1989	Changes in the number of population against 1989, %
Vilnius	542 287	576 747	-6
Kaunas	378 943	418 087	-9
Klaipeda	192 954	202 929	-5
Siauliai	133 883	145 629	-8
Panevezys	119 749	126 483	-5

Table 4: Changes in the Number of Population by Sex

Census year	Number of population			Specific weight in total number of population, %	
	total	males	Females	males	females
1989	3 674 802	1 738 953	1 935 849	47.3	52.7
2001	3 483 972	1 629 148	1 854 824	46.8	53.2

Population structure by sex showed the most distinct disbalance after the Second World War. Later women's ratio against men slightly improved, while since 1993 it started worsening again. In 1989 the number of females per 1000 males equalled 1113, whereas that in 2001 totalled 1139.

Monetary Household Income

Average monetary household income makes up about 901 to 1,000 litas per month. In order to evaluate the level of household income and the composition of income, households were divided into deciles (see Table 5). The levels of household monetary income differ considerably by income groups. Monetary income of ten percent of the poorest households totals 251 to 300 litas, while that of ten percent of the richest households ranges between 3,001 and 5,000 litas, so it is ten times higher. Monetary income of households in the first decile comprises about 30 percent of the average income, while that in the tenth decile is more than three times higher than the average.

The youngest households, consisting of persons under age 30, self-employed households, households without children or with one child under age 16 as well as households living in large cities receive the highest monetary income. The lowest income was reported by households consisting of persons aged 60 and over, pensioners, disables individuals and other persons unable to work, jobless persons, households with three or more children under age 16 and rural households.

Table 5

Monetary income (average[1])	Monetary household income after tax in deciles									
	I	II	III	IV	V	VI	VII	VIII	IX	X
Total income	251-300	451-500	601-700	801-900	901-1,000	1,001-1,250	1,251-1,500	1,751-2,000	2,001-2,500	3,001-5,000
Labour income (wages)	Up to 50	151-200	351-400	351-400	451-500	801-900	901-1,000	1,251-1,500	1,751-2,000	2,001-2,500
Non-wage labour income	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	101-150
Income from ownership	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50
Pensions and benefits	201-250	201-250	201-250	251-300	201-250	51-100	51-100	51-100	101-150	Up to 50
Other income	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	Up to 50	51-100

1. The table presents average income indicators. The average indicators are calculated on the basis of survey respondents' codified answers, which makes it possible to present them in intervals. Given that the average indicators are used, the decile figures increase in unequal increments. The average and the median are the same.

It is important to note that, in comparing the level of household income by regions, the biggest differences are observed from the eight decile and upwards. Households living in the Vilnius, Kaunas and Marijampole regions and representing the eight decile receive from 2,001 to 2,500 litas of monetary income per month, while those in other regions reported from 1,3001 to 1,450 litas.

2. Housing Sector Overview

After proclaiming its independence from the Soviet Union, Lithuanians focussed on the restitution of Lithuania as a state which occurred on March 11, 1990. The newly formed Government of Lithuania introduced economic reforms to facilitate the transition from a planned economy to a market-driven economy. As a result, the country's housing sector underwent mass privatization of public housing in the early '90s[1]. Prior to 1990, the majority of the housing stock (i.e. over 70 per cent) was under the tenure of public ownership administered by the state. After 1994, private ownership accounted for 87 per cent of the housing stock. Furthermore, the Government restructured many legal, financial and institutional entities to create an infrastructure that would support the housing sector.

As the Government of Lithuania continues its pursuit of adopting economic reforms to facilitate the transition to a market-driven economy, the country's housing sector continues to evolve. New organisations are being created to meet the needs of developing housing markets such private real estate companies, mortgage brokers, the State Land Cadastre and Register, the Central Mortgage Office, etc.

2-1. Housing Supply Availability

Dwelling Type

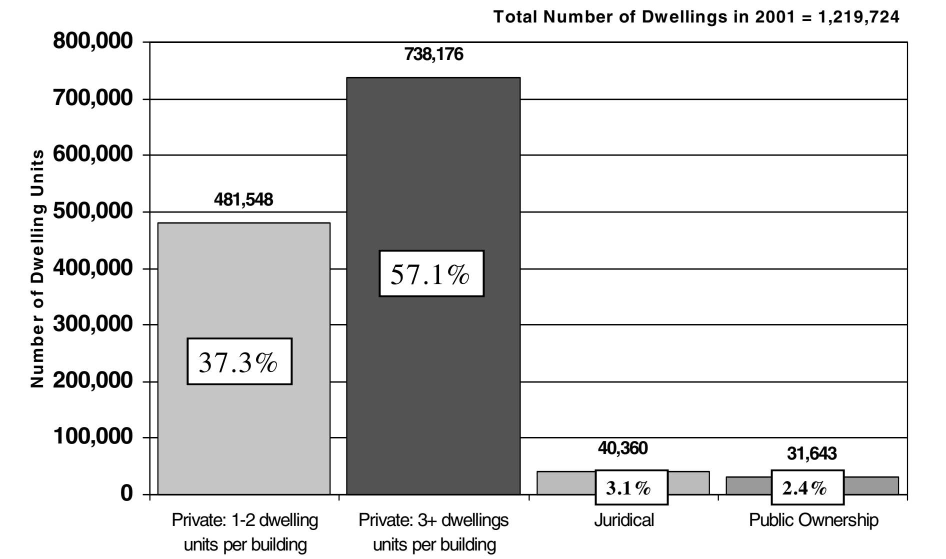
According to Statistics Lithuania, at the end of 2001 the country's housing stock consisted of 1,291,727 dwelling units. The majority of dwellings, 57.1 per cent (i.e. 738,176 units) are found in private multi-family structures (3 and more dwellings units per buildings) while 37.3 per cent of dwellings, 481,548 units, are in private single-family structures (i.e. 1-2 dwelling units per building).

The remaining 5.5 per cent of the housing stock is split between legal entities (i.e. housing co-operatives) with 40,360 units and public housing with 31,363 units, representing 3.1 per cent and 2.4 per cent respectively (see Figure 1). Note that former housing co-operatives and enterprises/organizations are legal (juridical) persons. Co-operatives do not exist any more; homeowners associations are replacing them.

The number of dwellings found in each of Lithuania's ten counties varies. Two counties have the dominant supply of dwellings, the county of Vilnius with 326,637 units and the county of Kaunas with 259,367 units; these two areas possess 45.4 per cent of the national dwelling stock.

When examining the housing choice available in Lithuania's seven major municipalities, on average 80.8 per cent of dwellings are found in private multi-family structures. Private single-family structures account for only 10.8 per cent of the dwelling supply in the seven major municipalities characterized by a strong concentration of dwellings in private multi-family structures.

Figure 1



Source: Statistics Lithuania; Stock of Dwellings and Construction, 2001, B902, Vilnius 2002

New Home Market

Since 1990, the number of newly completed residential dwellings has progressively declined. Over the span of twelve years, the number of new dwellings completed has dropped from 22,100 dwelling units in 1990 to 3,785 dwelling units in 2001 (see Table 6). Most of the decrease in residential construction activity is due to a drop in multi-family construction (see Figure 2). In 2001, residential construction activity fell by 13.3 percent, both single-family construction and multi-family construction recorded drops in activity, by 6.8 percent and 18.5 percent respectively when compared to 2000 (see Figures 3). In addition, the composition of residential construction between single-family buildings and multi-family buildings has changed substantially from 10:90 in 1990 to 48:52 in 2001.

Table 6

Residential Construction, 1991 - 2001, (Dwellings Completed)												
	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001***
1-2 dwelling buildings	2,300	1,200	1,700	1,400	1,800	2,232	2,343	2,386	1,890	1,674	1,930	1,798
3 + dwelling buildings	19,800	14,100	11,000	6,800	5,100	3,368	3,281	3,176	2,286	2,690	2,437	1,987
All residential dwellings	22,100	15,300	12,700	8,200	6,900	5,600	5,624	5,562	4,176	4,364	4,367	3,785
(Distribution of dwellings completed for specific year)												
1-2 dwelling buildings	10.4%	7.8%	13.4%	17.1%	26.1%	39.9%	41.7%	42.9%	45.3%	38.4%	44.2%	47.5%
3 + dwelling buildings	89.6%	92.2%	86.6%	82.9%	73.9%	60.1%	58.3%	57.1%	54.7%	61.6%	55.8%	52.5%
Growth Rate (Yr/Yr change)												
1-2 dwelling buildings		-47.8%	41.7%	-17.6%	28.6%	24.0%	5.0%	1.8%	-20.8%	-11.4%	15.3%	-6.8%
3 + dwelling buildings		-28.8%	-22.0%	-38.2%	-25.0%	-34.0%	-2.6%	-3.2%	-28.0%	17.7%	-9.4%	-18.5%
All residential dwellings		-30.8%	-17.0%	-35.4%	-15.9%	-18.8%	0.4%	-1.1%	-24.9%	4.5%	0.1%	-13.3%

Source: Statistics Lithuania, Statistical Yearbook of Lithuania 2001; * Statistics Lithuania; Stock of Dwellings and Construction, 2001, B902, Vilnius 2002

An indicator that helps describe the rate of new home construction over time is the number of new dwellings completed per thousand inhabitants. In 2001, there were 3,785 new dwellings completed giving a rate of 1.09 new dwellings completed per 1000 inhabitants (see Table 7). Since 1990, the rate of new construction has progressively fallen from 5.96 new dwellings completed per thousand inhabitants to its lowest level of 1.09 in 2001. This decrease in residential construction is attributed to a drop in state-sponsored construction. The Private sector construction has not compensated for the sharp decrease in government-sponsored construction.

Table 7

New Home Construction (in Dwellings Completed)							
	1995	1996	1997	1998	1999	2000	2001 *
All Building Types	5600	5624	5562	4176	4364	4463	3785
1-2 dwelling buildings	2232	2343	2389	1890	1674	1904	1798
3+ dwelling buildings	3368	3281	3173	2160	2580	2559	1987
Per 1000 inhabitants	1.54	1.55	1.55	1.17	1.23	1.27	1.09
Average floor space per dwelling, m^2							
All Building Types	101	112.2	109.2	119.8	120.7	113.5	101.8
1-2 dwelling buildings	160	180	166	172	174.6	168.6	142.3
3+ dwelling buildings	62	64	66	77	87.6	72.5	65.2

Source: Statistics Lithuania, Statistical Yearbook of Lithuania 2001; * Statistics Lithuania; Stock of Dwellings and Construction, 2001, B902, Vilnius 2002

According to the Lithuanian Builders Association, there are approximately 700 operational building companies in Lithuania, 130 builders are registered with the Association. There is a large amount of available capacity in the industry to respond to an increase in demand for residential construction. For example, the Lithuanian Builders Association estimates that the building industry could build 20,000 dwelling units a year.

Figure2

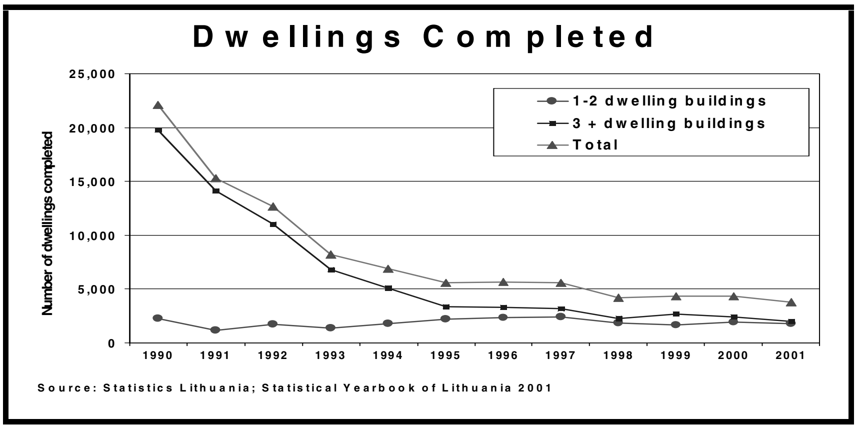
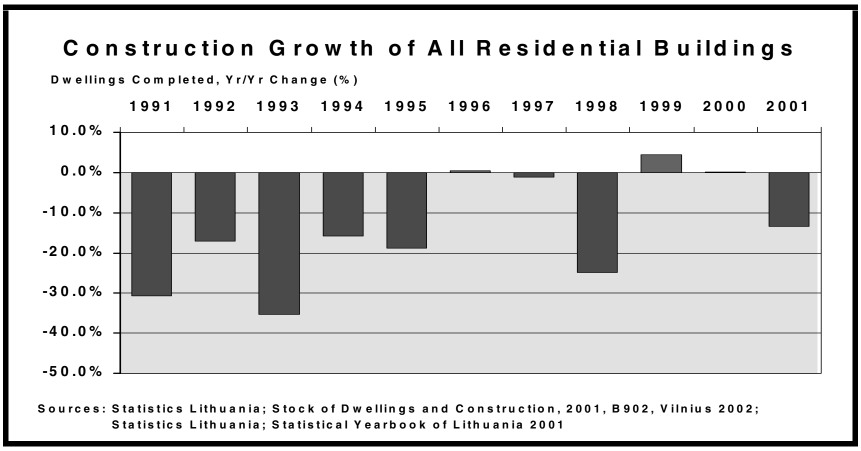


Figure 3



The size of new dwelling completed has varied over the years. For example, in 1995, the average size of a dwelling completed in new multi-family building was 62 m² while the average size of a dwelling completed in a 1-2 family structure was 160 m². In 2001, the average size of a dwelling completed in new multi-family building was 65.2 m² while the average size of a dwelling completed in a 1-2 family structure was 142.3 m². The average size of new dwellings completed was the biggest in 1999, with 174.6 m² for dwellings in multi-family structure and 87.6 m² for dwellings in 1-2 family structures. In general, the size of newly completed dwellings in multi-family structures is 30 per cent bigger than its counterpart found in the existing housing stock, 65 m² compared to 50 m². Furthermore, the size of newly completed dwelling of 1-2 family structures is 73 per cent bigger than the average, 142 m² compared to 82 m².

Although information on prices is difficult to obtain for many regions of Lithuania, data provided by Ober Haus Real Estate Company reveals that the price of new homes vary substantially depending on their location, finishing and size. For example, in 2001, a new house of 120 m² with no finishing would sell for approximately 384,000 litas in the City Centre of Vilnius, 336,000 litas in one of Vilnius prestigious suburbs, 312,000 litas in the City of Klaipeda, and 96,000 litas in the City of Kaunas. On the other hand, a new house of 200 m² with complete finishing would sell for approximately 800,000 litas in the City Centre of Vilnius, 720,000 litas in one of Vilnius prestigious suburbs, 720,000 litas in the City of Klaipeda, 640,000 litas in the City Centre of Kaunas, and 360,000 litas in the suburbs of Kaunas (see Table 8).

Table 8

Sample Resale Prices of Houses in Lithuania, 2002 (in Litas)						
	New (120-200 m²)		**Renovated** (120-180 m²)		**Unrenovated** (120-180 m²)	
	Min.	Max.	Min.	Max.	Min.	Max.
Vilnius City Center, Old Town	384,089	799,668	384,089	719,702	191,838	431,945
Vilnius Prestigious Suburbs (Naujamiestis, Antakainis, Zverynas)	336,026	720,254	311,995	648,229	144,189	359,851
Kaunas City Center, Old Town	96,126	640,149	--	--	--	--
Kaunas Suburbs	60,079	359,782	--	--	--	--
Klaipeda Suburbs	311,995	720,254	263,932	576,134	167,806	395,898

Source: Ober Haus Real Estate Company, July 2002

Land Development for Residential Use

In the existing databases of Land Services, there is no distinction between raw and serviced land. It is not known how many square meters of land are available for residential construction, just general areas are identified. In general, the development of land for residential construction, also known as 'state owned land', is at the disposal of ten counties, which can transfer the land rights to the municipalities for their own use (e.g. development of business centers, municipal housing and etc). Land can be transferred in three ways: firstly, by a specialized decree by the Government to give the usage rights to the Municipalities to fulfill their functions. The land can than be bought by private developers from the state only through auctions. Secondly, developers buy land from private persons, whose ownership rights have been restituted, as part of the land reform. This is a popular choice for developers. It is noteworthy to mention that the restituted land is usually considered to be for agricultural use, and it is up to the Land Service and the Municipality to change its status. Thirdly, the Municipality has a General Plan. Upon completion of the purchase transaction, the buyer prepares a detailed plan, which is integrated into the General Plan. The application is submitted to the Municipality using defined procedures. This process takes six months and is considered costly[2].

According to Vilnius City Municipality, the responsibility for residential land infrastructure lies with the municipalities. However, it is the developer, builder, and owner that finance the infrastructure. The cost of developing the infrastructure is normally included in the price of dwellings. This practice would explain the higher prices in the center of Vilnius due to the heritage and preservation regulations that make it costly to develop in some areas[3]. In addition, when rural land is turned into residential land lots, it is up to the developer/builder to prepare new plans, incorporate them into Territorial Development Plans and develop the areas. Territorial Development Plans exist in Vilnius, Klaipeda, partly in Kaunas, Panevezys and some other smaller municipalities.

2-2. Current Housing Demand

High level of home-ownership and small proportion of renters

Lithuania has one of the highest levels of housing ownership compared to countries in both Europe and North America. The private sector owns 97.6 % of the housing stock compared to 2.4 % ownership by the public sector (social housing), the latter mainly owned and operated by municipalities. In the private sector, a small proportion of the housing stock (3.1%) is owned by legal entities, which can be either profit or non-profit organizations such as housing cooperatives.

According to Statistics Lithuania, 87% of households live in a dwelling they own, which could define them as home-owners: 8% live in dwellings owned by friends or relatives, and 3 % rent from a private person. The final 3% live in buildings that are either state or organization owned. It means that private person could own more than one dwelling and rent one of them. Similarly, since the Free

Market Institute's Household Study 2002 shows that 82.6% of households live in dwelling which belong to them. All the other households could be considered as renters; of these, 10.5% live in a dwelling owned by other natural persons, 1.7 % rent from an enterprise or a legal enterprise, and 3.8 % rent from the State or municipality. A small group does not know who owns their current living place.

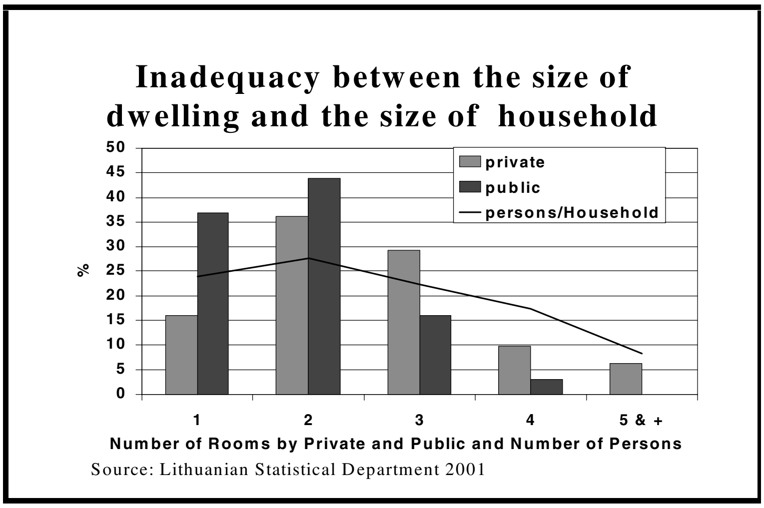
According to these facts, homeowners represent between 82.6 % to 87 % of all households in Lithuania. Renters are divided among those in social housing (3% to 3.8 %), those sharing a dwelling with friends or relatives, or renting from a private person (8 % to 10.5%). This last group appears more like an informal rental market.

In addition, homeownership is lower for young generations (60.4%), households with one child (77%), households living in main cities (79.4%), unmarried households (77.6%) and wage earners (79.4%).

Table 9. Homeowner and Renters

Statistics Lithuania		Free-Market Institute		Assumption
Form of ownership	%	Whose ownership is your dwelling	%	
Private ownership of the household	87	Ownership of your household	82.6	Home-ownership
State, organization ownership	3	State ownership	3.8	Rental social housing
n/a,	n/a,	Ownership of an enterprise, institution, organization or other legal entity	1.7	Private rental
Ownership of friends and relatives	8	Ownership of other natural persons	10.5	Informal private rental
Rented by private person	3	n/a,	n/a,	Private rental
Other	0	Other	1.4	Don't know

Figure 4: Inadequacy between the size of the dwelling and the size of the household



Lithuania's current housing stock offers primarily one to two room dwellings (54.3%). Lithuanian households are composed on average of 2.6 persons (2001). The distribution of households shows that the current housing choice is limited for households of three persons and more. The shortage is more evident for households of more than 4 persons: only 16 % of dwellings have 4 rooms compared to 26 % of the households that are composed of 4 persons and more.

The Free Market Institute's Household Study shows more inadequacy between current housing choice and housing needs: 52% of households with 3 persons live in small dwelling (2 rooms and less) and 40 % of households with 4 persons live in the same conditions.

In general, most wage earners and persons of non-defined socio-economic status live in small dwellings. As suspected, about 15 % of households who are in the highest two income deciles live in dwellings with 5 rooms and more. In rural areas, households could access larger dwellings: 33.6% live in 4 rooms and more. A high percentage (41.4%) of young households (age up to 30 years old) live in a one-room dwelling: this could be explained by marital status (not married households have the highest rate in one room: 33.3%), being a student (the higher the education, the higher the percentage living in one room: 26.6%). However, this does not seem be linked to income distribution. The percentage of households living in one room is nearly the same for each income decile, and even a little higher for high-end income.

Estimation of housing demand

Housing demand based on housing needs will vary according to the household or person's life cycle. On a first level approach, individual housing needs depend mainly on the age of the person, their family situation, and the number of persons (single, married, with children or without children, living with parents).

A higher level of aggregation defines the total housing demand with three different components: pent-up demand, potential housing demand and effective demand. Pent-up demand is demand from households who are waiting to get into the market: to buy or to rent. Potential demand is based on the household formation; in other words, it is based on population growth and the probability of forming a household by age group. The effective demand may be lower than the potential demand as it is constrained by affordability and consumer preferences. Potential demand (basic needs) becomes effective demand in the absence of barriers to the housing sector, which can be the level of income and saving for a down payment, housing costs (price or rent, interest rate, transactions costs), financial tools (underwriting criteria), and labour market perspectives.

Overcrowding or doubling-up dwelling explain pent-up demand

Pent-up demand is the demand that had not been satisfied in the past. It could be estimated based on the number of households or families waiting to rent or to buy a dwelling when they have an opportunity. Due to some economic circumstances, those households or families have been living in housing conditions not suiting their needs or their aspirations. And, in some cases, some households or families are sharing a dwelling with close relatives or friends, or even renting a room from a private person.

For that reason, pent-up demand could include households who applied for a soft loan to buy a house or to rent a municipal dwelling. To apply for the housing program, those households must live in poor conditions, namely, in less than 10 m² per person. According to the Ministry of Environment's 2002 waiting list, 88 771 households were waiting for a soft loan and 18 730 households were waiting to rent a dwelling from municipality. In 2001, the housing program did not keep pace with the demand; only 3 % of applicants received a loan or rented a municipality flat. In brief, about 100 000 new dwellings were needed in 2002.

Table 10

Number of families waiting for state support in dwelling acquisition or rent		
Year	Families waiting for state support for a soft loan	Families waiting for state support to rent public dwellings from municipalities
1995	78727	14608
1996	80849	14110
1997	82146	14005
1998	90001	14259
1999	89813	15159
2000	88180	16274
2001	87764	17141
2002	87771	18730

Source: National Report on Sustainable Development Implementation, 2002

Table 11

Number of families receiving state support in dwelling acquisition or rent		
Year	Families receiving state support for a soft loan	Families receiving state support to rent public dwellings from municipalities
1999	1162	1078
2000	351	685
2001	2526	901

Source: National Report on Sustainable Development Implementation, 2002

Another measure of pent-up demand could come from the indicator for overcrowding or doubling up: households[4] who share a dwelling with another household. In most countries, one household occupies one dwelling. According to the latest Census data for population, an estimation of 1.339989 million households live in 1.291727 million dwellings - the ratio of household per dwelling being 1.04[5]. That means 4% of the total households share a dwelling with another household. Consequently, to fill the gap and to obtain a standard of one household per dwelling, 48262 new dwellings are needed.

The Free Market Institute's Household Study shows a higher ratio for doubling up: 9.4%. The probability of sharing a dwelling is higher in rural areas (13.1%) than in the five main municipalities in Lithuania. This could be explained by two factors: fewer dwellings are available in rural areas but they have more rooms than in urban centres, thereby increasing the possibility of sharing. From a different perspective, the doubling-up indicator could be overestimated due to confusion between what is a household and what is a family. For instance, 16.5 % of households with three generations in the family declared that they are living with another household. It is unlikely that a three generation household could accommodate another household. As reported, rural families are more inclined to have grandparents, parents and children under the same roof; this statement confirms the higher doubling up ratio in rural areas. So it makes sense to say that the doubling up is over-estimated to some degree due to how respondents understand the definition of household.

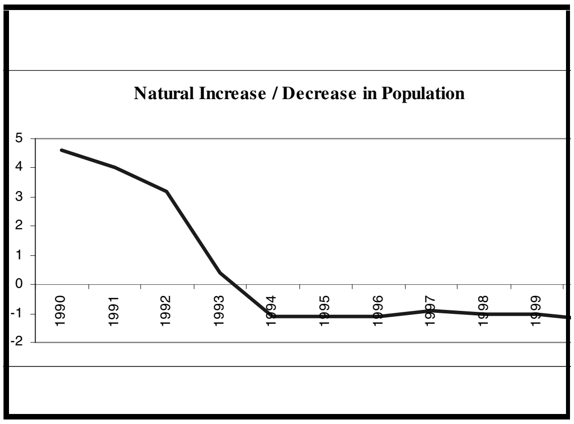
However crowding could be illustrated by number of person by room (1.06) and by person per m² (22 m²/per capita). Those indicators are higher than indicators for most European countries. In conclusion, the pent-up demand of 100 000 units comes mainly from households needing to improve their housing conditions in terms of living floor space and especially the number of rooms in a dwelling, rather than a shortage in the number of dwellings.

Potential housing demand

Potential housing demand is mainly dependent on the demographic profile of a country. Factors like the rate of growth of the population and age structure play an important role in determining the demand for housing in the medium and long term. Since 1994, there has been a slow decrease in the population of Lithuania due to mortality exceeding the birth rates in the country (See Figure5). The average number of children per women has been decreasing, so much so that it is slightly below the level required for a sustainable population. The fertility rates have declined considerably during the last decade – from 2.02 in 1990 to 1.28 in 2000.[6]

Another factor affecting the increase in population is migration. Lithuania experienced a high level of out-migration since its Independence. The trend has decreased, but still is more important than immigration due to a competitive job market in neighbouring countries.

Figure 5



3. Savings

Savings is the amount of money left after expenditures and investments, and could constitute a source of funding for future expenditure. Savings, in some part, are motivated by the type of society as well. In consumption societies they tend to be lower as goods and services are bought, allowing for lower levels of cash in hand, whereas in savings societies people tend to have more cash on hand because of the liquid nature of the asset and in order to provide support in future uncertainties. In Lithuania the level of savings has been increasing but it has not been followed by an increase in investments[7], which means that people are no longer foregoing current consumption for future. The current household situation - wherein 54% of the households are living on the edge of subsistence and only 24% are able to save some money - calls for a waiting period for housing finance, since housing is a long-term investment and a considerable amount of savings have to be made.

Apart from the various factors listed above, the overall economic conditions in the country tend to have influence on the decision making process of an individual. While the above factors are more micro in nature, others like political stability, gross domestic product, a sound financial system and standard of living are more macro in nature. The migration pattern of Lithuania shows that about 70% of the people leaving the country are those who are or could be a part of the active labour force as they are in the age bracket of 15-59 years. To some extent this is compensated by the fact that 50% of the people coming into the country are from the same age bracket. Residents of a country facing any level of uncertainty in the future in any respect are likely to behave in a very different manner than those who are not. The approach to a concept or an idea also varies with the socio-economic environment.

Lithuania is in its formative phases of the developmental process. The people in the country are doing better but are still struggling with basic issues of employment and income. The prioritization of needs is presently more towards current than future consumption.

Saving and borrowing to improve housing conditions

When it comes to saving for housing improvement, 38 % of those surveyed answered positively, and this percentage is the same across age groups to 59 years old. Households in which the head is 60 years old are less likely to save for improving housing conditions. Household with 3 and more children are in the same situation (15 %). The correlation of saving power and income deciles is evident: 52 % of the highest income deciles saved for home improvement compared to 21 % in the lowest incomes deciles.

Borrowing for home improvement is not yet a common behaviour among Lithuanian households. Overall only 7% of all the respondents have ever take a housing loan from a bank. The higher the education of the households, if they have lived in major municipalities or in places with more than 200 000 habitants, and earn more than 2000 Lt, the more likely it is that they have had a loan or currently are taking a loan; this is approximately 11%. The main sources for their financing are: their own savings (51 %), loans from the work place (2.6%), friends and relatives (11.3%), and leasing (0.8 %).

Despite this low level of experience with bank loans, attitudes seems to be changing: 19 % of households mentioned that they intend to take a bank loan if they intend to improve their dwelling conditions. It is more evident for younger generation households (33%), for household of three members (31%), for wage earners, employers and farmers (about 22 to 25 %), for household with higher education (26 %) , for household of two generations (23%), living in average size of municipalities (31%), living in main cities (26 %), and for those with higher-income (30 %) .

4. Mortgage Demand

Lithuania's mortgage activity in is still at the beginning of the cycle. The residential mortgage division of banks, the Mortgage Insurance Company and the Central Mortgage Office have really been operating since 1997, 1998 and 1999.

Table 12. Number of residential sales

	1998	1999	2000	2001
Flats	39238	30294	23814	26637
1-2 Family Houses *	10697	10478	9072	7398

Source: State Land, Cadastre and Register

** Category includes individual houses, summer houses and farms*

Mortgage demand is influenced by interest rates, underwriting criteria and is mostly derived from the total transactions. In Lithuania, about 20 % of buyers get a loan from banks which can insure high-risk loans (high ratio loan to value).The Mortgage Insurance Company is in charge of insuring soft loans (government program of interest rebate). In 2002, due to the fact that it is at the end of the program, it has a high rate of activity (35 %), and the rest are commercial loans (with a loan to value ratio of 80 to 90 %). According to information, in October 2002 the Mortgage Insurance Company insured approximately 20% to 23 % of the entire commercial residential mortgage market. Underwriting criteria for commercial loans uses an effort of debt ratio of 40 % of disposable income, plus another criteria for income left for living subsistence for every family member: for instance with a down payment of 10 %, after paying the mortgage payment, the first person of the family must be left with 1000 Lt, and 350 Lt for each additional person of the family.

According to information collected, the average age of borrowers is 29 years old, the average loan for Lithuania is 65 000 Lts and higher for Vilnius (88 000Lt), and both soft loans and commercial loans have an average value of 100 000 Lts for Vilnius and 75 000 Lts for other places. Housing could be affordable for some households because the calculation of disposable income is the sum of all incomes of household members (husband and wife, children, grand-parents).

Insurance premiums vary depending on the loan to value ratio, to existing or new dwellings, and if a premium is added to the loan. The rate of the premium decreased in 2002 and will continue to decrease in 2003. This will encourage more bank loans and facilitate the use of financing to leverage housing activity. An even more important factor that may stimulate housing consumpt-ion and financing is the new program for residential mortgage interest tax deductibility in 2003.

As seen above, few households use loans from banks to buy a house. The vast majority of households use their own savings, loans from work places and more frequently loans from relatives and friends. Therefore, mortgage demand is low, 7 000 loans, about 20 % of the total transactions of 35 000. This trend may be higher in the near future if awareness of housing opportunities and financing tools increases among consumers. In brief, mortgage demand [8] represents a potential of 7 000 loans a year for a total of 455 million Lt per year. However, two key variables will influence the volume of loans: housing market activity and changing attitudes of consumers.

5. Social Assistance Programs

Lithuania has had two important means-tested benefits, the Social Benefit and the Utility Compensation. They are both designed to assure that a low-income household has access to a minimum amount of funding for ordinary consumption. The Social Benefit (SB) provides a cash payment to those with family incomes per person less than a state-set minimum. The Utility Compensation (UC) pays all of the heating and water costs above some income based contribution and below a normative maximum based on family size and location.

In 2001, there were about 116,000 individuals in families which benefited from the Social Benefit. All in these families plus another 3454,000 individuals benefited from the UC. The number of such additional (non-SB) recipients increased over 100% from 2000 to 2001, because many families with average incomes found that they are also eligible for it.

These two benefits have not been integrated nor have housing expenses other than utilities been integrated into the benefit equation. However, extensive work has been done on developing such an integrated package. In fact, proposals to integrate all basic living costs, utility costs and housing maintenance costs into one means-tested benefit, have been formulated since at least 1997.

So far, however, budget limitations as well as traditional distinctions between housing sector issues and social welfare issues have prevented it. In addition, it is commonly felt that, not only do many or even most people hide some income from the tax authorities, but that many of those who have no official employment are engaged in off-the-books activities. On the other hand, there is a pressing need to provide some sort of means-tested subsidy to the costs of energy-saving renovations of buildings.

The government has introduced recently a draft law that would place the two programs under the same law and make some small changes to the existing programs. One key change is that the applicant would have to account for the family's assets. There would be normatives for the size of the housing unit and the value of the other assets, and the applicant would be ineligible if the normatives are exceeded. For example, the draft law provides a ceiling of 50 sq. meters for 1 person and 15 sq. meters for each additional household member. Movable property is limited to 30 times the SSI, or LTL 4,050 currently.

Another important change is the granting of the Social Benefit to those who have been unemployed for more than 12 months, as long as they are registered and available for work, including public works programs.

A final change is to pay only 80% of the gap between the per person household income and the SSI for each child. This is the first incorporation into the program of the fact that household expense needs do not rise equally with additional family members.[9]

6. Soft Loan Program

As in all other transition countries, there was an effort to continue some form of state assistance to those in the queue for housing. The first and most costly response to this was a program called the Bustas program. The Bustas program was initiated early on in the transition period, in 1992. From 1992 to 1997, it was financed out of an extra-budgetary source, the so-called General Support Fund for Dwelling Construction or Acquisition. This Fund held about LTL 350 million. In the version since 1997, the maximum amount of aggregate lending in each year has had a (high) limit and the actual subsidies are being taken annually out of the state budget.

Between 1992 and 1997, most of these funds (78%) were used for loans for the completion of co-operative projects that were already scheduled as of 1992. The remainder was made available for the construction or acquisition of private houses.[10] Since 1998, the main objective of the Bustas program is state support of acquiring a residential house or apartment, either owner occupied or a municipal rental.

Persons eligible for state support under the Bustas program (other than for the co-ops before 1998) are listed on waiting lists in the municipalities to which they belong. There are three waiting lists:

3. The general waiting list for everybody who has less floor space than the general norm of 10 square meters per family member, or who has living premises which do not comply with appropriate technical and sanitary norms.

4. Waiting list for the needy (including invalids, disabled, retired, etc.)

5. Waiting list for young families (each spouse not over 35 years of age, or singles with young children) who do not own a flat.

The waiting lists (including ranking of persons) are maintained by municipalities. Each year, municipalities update the list from 1 January to 15 February. This aspect is important, because there are households who would be eligible, but who do not apply during this window.

For support in the form of a subsidized loan, one must comply with defined criteria regarding a limited amount of floor space per person. However, in practice, this is a limit only on the amount of the loan that is subsidized, and additional space can be financed in other ways, including an additional loan at a commercial rate. Notably the amount of space allowed under the rental option is substantially less than under the purchase option and thus the purchase option is generally more popular (despite the low rents).

For needy persons (according to a definition in the law; category 2 above), the rate on the loan may be 0%, and, in some cases, the repayment shall exclude up to 10-20% of the disbursed principle (apparently meaning that the state will pay off this proportion of the loan amount at time of origination). However, given the low incomes and distressed economic circumstances of such households, they tend to not be eligible for market-based credit and need to wait for access to a low-rent municipal flat.

The operation of the soft loan (as it is known) portion of the Bustas program has changed significantly over time. From 1992 to 1997, it was operated solely through the state-owned banks, the Savings Bank and the Agricultural Bank, with the funding itself coming from the Bustas fund at a 0.0% rate, and loans made for 25 years at a fixed margin of 5.0%. By their nature as state banks, there was not much focus on the underwriting process and on the ultimate concern about avoiding defaults. It appears that originally the state was guaranteeing only a portion of these loans, but, in the privatization process, the government has taken on the full credit risks.

The first significant shift came when the initial funding for the Bustas program was used up in 1997. Now the Government had to fund its subsidy scheme by coaxing the banks into funding and making the "soft loans" themselves. This led to a tender being requested for such lending, with the bank providing the funds and the state providing the interest rate differential. Two commercial banks (Vilniaus Bank and the State Savings Bank) offered to take on this task on a limited amount of funding and on certain terms set by each bank.

These two banks had already inaugurated a small amount of mortgage lending on a normal commercial basis in 1997 and 1996 respectively. But the Bustas scheme was focused on people who had been on the waiting lists for a long time. Thus, those granted eligibility by their municipality had been on the waiting list the longest and were not always of a situation that would make them an attractive commercial risk.

In July 2001, the program was expanded to the Agriculture Bank and the new Finnish bank, Sampo.

The nature of the subsidy on the soft loan has also changed. As noted, before 1998, the rate on the loan was 5.0% and the funding came at 0.0% from the state. From 1998 through 2000, the subsidized rate remained at 5%, and the state paid the difference down to that rate from the rate asked by the bank (12% in 1998). In 2001, the program was not operable until July, and, with bank rates dropping below 8%, the subsidy was recast as a 6% reduction from the market rate asked by the bank. However, rates dropped even further so that this net rate was almost 0.0% or less, especially for loans in forex. In 2002, the subsidy was recast again to be 5% for loans in litas and 3% for loans in foreign exchange.

Since 1998, these subsidies applied only to half the period of the loan, with a maximum of 10 years. The presumption is that, after that time, the income of the borrower would be sufficient to bear the market rate.

In the early years of the Bustas program, the amount of the loan was limited to 80% of the appraised value. When the banks took over full risk exposure, this maximum dropped to 70%. But this situation changed significantly with the establishment in 2001 of the mortgage insurance scheme permitting lending up to 95% of the cost of the home (for a fee). The very low downpayment permitted under this scheme combined with the low interest rate under the Bustas program meant that anyone with any significant earnings capacity could access a sufficient loan for acquiring a home, even without much available cash. In addition, the state picked up the full cost of the mortgage insurance provided by the state-sponsored mortgage insurance company for those eligible for the Bustas program.[11]

A final very significant modification of the Bustas program came in the spring of 2002. It seems that previously being on a list of eligible households was not sufficient to access the program. Because there was an official limit on the amount of soft loans each year (although never reached), subsidies were granted according to the priority on the list. This meant that (1) people on the list could not simply apply for a soft loan and (2) most of those actually officially offered the subsidy had been on the list for a long time. They were generally older and often with poor incomes. These groups were generally not good borrowers, compared with the younger families who were on the list because they simply had not acquired a house yet.

In February 2002, the procedures were changed to permit anyone on the lists to go to their municipality and ask for an eligibility letter, without waiting for the municipality to call their number.[12] This has created an influx of younger families with good incomes seeking mortgages, and made the banks more interested in making such loans.

Thus, under current conditions, every young family without ownership of a flat is eligible for a loan at an effective rate of 2% or less (although some cities have already used up their official allocation). The low rate can apply for a loan of up to 95% of the cost of a home, but if the home is larger or more expensive than the program norms (currently the case for about one-third of the soft loans), the excess must be financed at the market rate or by cash.

The volume of soft loans has grown significantly recently. In 2000, when the effective rate was still 5% but the program was not fully funded, there were only 350 soft loans made. In 2001, there were 2,520 soft loans granted. In 2002, this may expand to 3-4,000 loans, especially since access to the deep subsidy will end this year.

The current interest subsidy is scheduled to end as of 31 December 2002, for the stated reason that it is too expensive, to be replaced with a program of deductibility of mortgage interest for tax purposes. It is not clear yet how exactly this deduction will be applied and whether in fact it will be less expensive or mostly just hidden off the budget. This depends on whether similar restrictions apply as to who gets the deduction or if it becomes available to all mortgage borrowers. However, it is viewed as a substitute subsidy, worth about 1.5-2.0%, for those who are currently eligible for the soft loans.

7. The Soft Insurance Subsidy

The second significant government intervention, and, broadly speaking, a subsidy, was the creation of the Lithuanian Mortgage Insurance Company (LMIC). The decision was made in 1998, the company was organized in 1999, and the first loan insured in July 2000. It appears that this was decided independently by the government, without outside sponsorship, but perhaps partly based on the suggestions by observers from countries were governments sponsor such insurance. With the private banks becoming heavily involved with the soft loan program starting in 1998, they had an incentive to shift risk to the government and presumably were very supportive of this step.

The LMIC is fully government-owned, but it is expected to operate on commercial principles. In fact, the incoming Vice Minister of Finance in 2001 required that the official guarantee of the government be withdrawn, so that today the full reliance of lenders is placed on the technical reserves of the company.[13]

Initially, the insurance provided 100% recovery of principal, but no interest, late fees or penalties. In 2002, this coverage was cut back to 25% of principal, plus 4 months of interest arrears and the cost of property insurance, appraisal, and the borrowed portion of their insurance premium. The maximum premium in 2001 (for 100% coverage) was 7.78% for a 95% LTV loan. This was reduced to only 4.34% in 2002 for the lower coverage (see above).[14]

Notably, this premium can be borrowed from the lenders.[15] But it partly pays for itself through a discount offered by most lenders when insurance is taken. Insurance is mandatory for soft loans, and the state pays for half of the insurance in these cases. The state also pays for half of the insurance premium when the borrower meets the general requirements to be eligible for a soft loan but does not receive a soft loan. This can occur because they did not get on the waiting list for the municipality where the housing is (many want to buy a house in a new municipality, but have no standing to get on that list) or, prior to 2002, they were not yet allocated access to a soft loan.[16] In addition, more than a quarter of LMIC's volume of business is insuring loans given at commercial rate, presumably when the borrower wants to exceed the normal LTV ratio.

In 2001, its first full year of business, the LMIC insured 2181 mortgages, of which 1554 were soft loans[17] and 627 were on commercial basis. This was about half of all loans made in 2001 (roughly adjusting for the difference between dating procedures for loan approvals, disbursements, and insuring). It is expected that there will be about 4,000 loans insured in 2002. The average size of the insured loan is about LTL 60-70,000.

It is too early to know if the LMIC is a significant subsidy to the mortgage sector. The banks clearly do not treat it in that manner, in the sense that they do not routinely use its services for regular (unsubsidized) loans with LTVs of 80% or less. It is used, as required, by the banks for all of the soft loans (most of which have LTV's of 95% and so would need insurance anyway), but they are willing to accept an LTV up to 85% on a new house without any insurance.

The lack of interest in using insurance in order to take higher LTV loans may reflect the general availability of sufficient downpayment amounts plus the willingness of banks to accept lower downpayments in many cases. The use does not seem to be sensitive to the charge. As noted, in 2002, the cost of insuring a loan with a LTV of 95% fell by 40%, from a one-time premium of 7.41% to 4.34%, and still only about 20% of regular commercial loans use this option (of course, their repayment capacity and the underwriting requirements of the bank are also a limit preventing many borrowers from accessing a LTV higher than 70-80%).[18]

8. Current Situation of Housing Finance Market

The situation has developed over the last two years, as the banking sector has been stabilized and in fact absorbed by strong foreign bank groups. This development has meant greater access to foreign funding and lending expertise, and a strong effort by the banks to establish market share. But it seems that some banks were already far along in developing loan products, based on experience developed since 1998 in making loans under the soft loan program and also a rising number of loans on commercial basis.

Rates, Lending Volumes, and Market Conditions

Data compiled by the Lithuanian Mortgage Insurance Company (LMI) indicates that there were 5,161 mortgage loans made in 2001. This was a large increase over 2000, when it seems that about 3,000 loans were made. Observers expect a further increase in 2002, suggesting a total of perhaps 7,000 CONFIRM. Since the average size of loan is about LTL 80,000 CONFIRM, the volume should be at least LTL about 600 million in 2002. This is about 1.2% of GDP. Clearly, mortgage finance has arrived in Lithuania.

Almost all of these loans were based on a floating market-determined rate of interest, plus some margin that is fixed for the life of the loan. The market reference rate depends on the currency chosen by the borrower (not all banks offer all currencies). It is VILIBOR for litas, EURIBOR for euros, and LIBOR for USD. Most loans had been in foreign currency in earlier years, because the rate was at least 2% lower, but the spread has declined and most loans are being made in litas this year CONFIRM. The borrower also has a choice of term of the rate, from 3 months to 1 year.

With the very low levels in 2002 for these reference rates, plus a decline in the margin over the rates, the effective interest rate on loans have dropped sharply. There is no data just for mortgages, but the Bank of Lithuania does have data on bank loans over 5 years in term. The average such rate, for loans in LTL, dropped from 9.45% in May 2001, to 7.82% in December, and to 5.55% in May 2002. Rates on loans in foreign currencies are even lower.

The usual term of the loan is from 15-25 years, apparently at the choice of the borrower. However, for soft loans (discussed below), the term is almost always 20 years or more, because the subsidy is available for half the life of the loan with a limit of 10 years. It is notable that the maturity on commercial rate mortgages as recently as 1999 was a maximum of 10 years.

Underwriting Parameters

There are minimum underwriting requirements for loans (whether soft loans or at commercial rate) that are to be insured by LMI. Lenders can adopt more stringent requirements. However, in the market for uninsured loans, the underwriting requirements have become more relaxed under competitive pressures.

For insured loans (about half the market in 2001), the minimum downpayment is 5%. However, the cost of the mortgage insurance, which is fully paid upfront, can be added into the loan, as long as it does not exceed 100%. Last year, this cost could be as high as 7.41%. This year, because of reduced coverage, the maximum charge is 4.34%, so the total loan amount will never exceed 100% in any case.

For uninsured loans, banks had been unwilling to go above 70% of the appraised value of the house. This has been relaxed to 80% in the current competitive market, probably in response to the fact that, as rates fell, the number of people who could qualify to borrow more than 70% rose rapidly.

For LMI, the loan amount to any individual is primarily limited by the person's income and how much of it is permitted to be applied to loan repayment. The general rule is that the loan repayment (not including costs such as property or life insurance) can be up to 40% of net income. However, this applies only if the amount remaining after the loan repayment exceeds what are viewed as minimum costs of living. Specifically, for a family of two adults, the minimum costs are LTL 500 per adult. For children, there is an addition to such minimum of LTL 375. Thus, if a family of 2 adults and 1 child has net earnings of only LTL 2,000 a month, the maximum repayment is only 500 LTL, or 25% of net income.

It seems that some private lenders are more liberal with respect to this minimum required remaining income.

At an interest rate of 6% and a term of 20 years, a burden ratio of 40% will permit a family to borrow 4.6 times their annual income. It can be argued that most families in Lithuania (and in Central Europe) are looking to acquire a house costing about 4-6 times their annual income. Thus, under current conditions, this underwriting limit would permit obtaining a loan of anywhere from 77%-95% of the cost of the house. This is a very high level of affordability.

The major caveat to this conclusion is that it assumes that the full amount of this income is from reliable, regular sources and is verifiable. People with significant amounts of income from sources that do not meet these conditions will find their loan capacity reduced (although they may have more cash available for application to the purchase as a result).

Other requirements include insurance on the property and on the life of the borrower(s). Apparently, this is an area of potential profit for the lender (and hidden cost to the borrower) since some lenders have captive insurance entities providing these coverages.

The market conditions on both supply and demand sides have also been strongly influenced by the higher rates of economic growth experienced since 1999. This has caused increased flows of liquidity into the bank system and improved confidence on the part of potential borrowers. However, there was also a specific supply-side spark that has driven the current expansion of lending. This was the arrival of two Finnish banks in 2001 which were particularly interested in using mortgage lending as a way of getting a foothold in the local market.

These banks, Nordea and Sampo, draw most of their funds directly from the central treasury of the mother bank in Finland (the Nordea bank in Finland is part of the largest banking group in Scandinavia). Thus, they lend primarily in foreign currencies. In addition, they are used to lending at a small margin in Finland, probably less than 2%. Nordea, in particular, seems to have strongly marketed their mortgages on the basis of a low margin (however, they do not participate in the soft loan program). The result has been to accentuate a decline in margins over the reference rate (e.g., LIBOR) which had already started in 2001, with margins declining from 5% in 2000 to a range of 3-4% in 2001 and to 2-3% in the last 6 months.

This situation, combined with cyclically low short-term money market rates, has put the interest rate on loans even in litas in the range of 6% or less. These margins and these absolute rates are almost as low as in most advanced Western countries. It is unlikely that either the margin or the reference rates will stay this low permanently. The possibility of a rise in margin and market rates raises concerns about the profitability of the loans to the banks and also the future payment burden on borrowers. It also means that this high level of affordability will not necessarily remain.

For this reason alone, 2002 should be a very strong year for mortgage lending in Lithuania. But in addition, the terms of the program of soft loans were relaxed in 2002 (although the subsidies were slightly reduced), as was the cost of the mortgage insurance. To top it off, the current plan is to end the current deep subsidy version of soft loan in 2002, and switch to using a tax deduction for mortgage interest as of 2003. Because the subsidy is greater under the soft loan program, it is likely that as many people as possible will try to get a soft loan before the end of the program.

Proposed Mortgage Bond Law

There have been two efforts to start up mortgage bonds in Lithuania. The first was initiated in 1997 by the Danish government and the World Bank, in cooperation with the Ministry of Finance. This first effort was focused on evaluating the situation in Lithuania for meeting the prerequisites for the establishment of a Danish-style mortgage banking system.

This initial effort did not lead to any specific actions. The principle recommendation was that a single Danish-type mortgage bank be set up, with government support, to serve as a central funding agent for all mortgage lending, and operate a retail mortgage lending arm itself. Apparently, the problem was that the government was not convinced that it was necessary or appropriate to start a system based on separate mortgage banking institution.

In any case, the initiative stalled in 1999, and lay dormant until recently, in late 2001. The process was then picked up with an effort to resolve remaining issues in the preparation of the needed legislation, to be followed by further technical assistance in the areas of supervision, evaluation, and other procedural issues. However, the focus is now on supporting the issuance of mortgage bonds by universal banks, not the creation of specialized mortgage banks.

The first component of the EU definition is that there must be a separate statutory basis for the protections that mortgage bonds offer investors. Thus, if the Lithuanian mortgage market is to benefit from this sort of fund-raising technique, a mortgage bond law is required.

First and foremost, Lithuania is at a stage in the evolution of its financial sector where, for the near-term, there probably will be little demand for using the bond issuance mechanism (barring the presence of subsidies). There is a stage in the deepening of the financial sector where the public becomes more comfortable with the safety and reliability of banks and the base of bank deposits grows rapidly as a share of GDP. Lithuania is in that stage, now that its banking sector is better supervised and under the ownership of strong foreign banks. The deposit base grew by 25% in 2001, and is headed for continued growth in 2002.

Probably the fastest growing part of the loan books of banks has been long-term residential mortgages, but the expected issuance of up to LTL 4-500 million in mortgages in 2002 can be funded by the likely rise in the deposit base of about LTL 1.5 billion. It is partly because of this situation that banks have cut their lending margins and more aggressively marketed their mortgage products.

The growth in the domestic deposit base of Lithuania is actually being augmented by inflows from the deposit bases of other countries. The two Finnish entrants into the mortgage market, Sampo and Nordea, use exclusively funds provided from their mother banks. These funds are a mix of deposits and unsecured bond issuances.

This environment will eventually change, both because the growth in the deposit base will slow and because there will arise institutional investors with an appetite for securities such as mortgage bonds. In fact, these two processes will be linked. Although the financial assets of Lithuanians may continue to grow at an overall rapid rate, a greater share of that growth will be in the form of pension assets and investment funds, including investment funds offering close substitutes to bank deposits, i.e., money-market funds.

Looking not too much further ahead, it can be seen that Lithuania will join the Eurozone, and, at that time, the asset and liability base of its financial sector will become even more closely linked to outside markets. Lithuanian assets will have to compete with other euro-denominated assets for a place in the portfolios of Lithuanian-registered (although perhaps foreign-owned) investors. Seekers of funding in Lithuania, including mortgage lenders, will have to compete with Euro-zone alternatives.

It is in that context, where there is slower growth in the deposit base and a growing opportunity to seek long-term funding from Lithuanian-based (as well as foreign) institutional investors, that banks and other lenders will have greater interest in funding their activities through the issuance of bonds. And where the potential advantages of having an EU-approved structure for mortgage bonds becomes more valuable.

At such a point, there will be an advantage to having a bond structure that most easily fits within the overall evolution of the banking sector. It should offer an explicit cost of funding that is lower than that attainable through issuance of unsecured bonds, but without much in the way of additional costs of implementation or operational complications. Otherwise, banks will choose instead to issue unsecured bonds, based entirely on their own credit rating.[19]

There is one other circumstance that would be supportive of mortgage bond issuance, sooner than that suggested above. That circumstance is if there is a desire (or subsidy) for use of loans with rates which are fixed for periods longer than one year. Such loans offer an advantage of delaying and possibly avoiding jumps in repayment burden associated with increases in the shorter-term interest rates that are currently used to set rates on most mortgages. The most common term for mortgage bonds is 5 years, and such funding at a fixed rate would permit banks to offer loans also with rates fixed for 5 years.[20] This is not the sort of long-term funding provided by mortgage bonds in Denmark or mortgage securitization in the US. But it can still substantially reduce the volatility of repayments.

Another consideration in designing a mortgage bond law for Lithuania is that the political and legal uncertainties about recovering on defaulted mortgages are not as low as in some other countries using mortgage bonds. In these countries, lenders have successfully survived crises in the housing sector and shown that mortgage loans are very reliable assets. There are three implications of this situation in Lithuania. First, the presumption that mortgage loans will provide a invulnerable basis for full recovery by bondholders in an economic and financial crisis is less certain. This implies the need for greater collateral coverage than normal. Second, the definition of a quality loan may need to be less liberal than in Spain. Third, this is another reason why the reduction in cost of funds achievable through mortgage bonds relative to unsecured bank bonds may not be as great as elsewhere.

It seems desirable for the law in Lithuania to build on the Spanish model, because there is no plan to restrict such bonds to special institutions.[21] The key to that model is that the collateral value of mortgages is the focus of the law.[22] There are two implications of this.

First, the perspective of the law is to define how the requirements for proper cover are to be met. The law does not prescribe the use of the proceeds of the issuance of a mortgage bond. Rather, it prescribes how the bonds must be secured and the characteristics of the mortgage loans that can be used in the cover required for mortgage certificates.

Second, the decision is made to replace mechanisms for "balance" or financial matching of mortgage assets and mortgage liabilities (beyond normal ALM requirements for the bank) with over-collateralization.

In place of complex balancing rules, the Spanish law requires that the certificates issued be not more than 90% of the value of the covering loans. (In practice, since Spanish banks rely on mortgage bonds for only a small part of their overall funding, the actual coverage ratios are much higher.) Secondly, the Spanish law permits the loan to be up to 80% of the appraised value of the property (if it is for housing).

It may be advisable that both a lower coverage ratio and a lower lending ratio be specified for mortgage bonds in Lithuania. For example, the lending ceiling per loan could be 70% and the coverage ratio be only 80%. This would assure that there is little chance of a loss in case of foreclosure (better able to withstand a sharp drop in house values), and that there is enough cash flow from the loans to service the mortgage bonds in case of bankruptcy of the issuer.

This conservative approach would also reduce the value of burdensome requirements related to special supervision or additional balancing rules related to matching the financial characteristics of the loans with the bonds (beyond the simple requirements that the average maturity of the bonds not exceed the average maturity of the loans). This extent of over-collateralization should cover most potential weaknesses from more liberal specifications elsewhere.[23]

A major drawback to this approach is that it makes it difficult for an institution such as the Baltic-American Enterprise Fund, which does not operate as a conventional bank, to rely on mortgage bonds for the bulk of their funds. In fact, 20% of the funds would have to come from other sources. These sources could include unsecured bonds. However, it is not clear that this issue is significant, because non-banks are unlikely to survive the competition of the banking sector in mortgage lending in the long-run.

A similar issue, with positives and negatives, is that such a provision may discourage foreign mortgage banks, who might otherwise enter the market without developing other funding. For example, one of the more active issuers of mortgage bonds in the Czech Republic is HypoVereinsbank, which specializes in financing commercial real estate. Such entities would have to tap some other sources of funds, either internally or externally, for a significant part of their funding. (Once Lithuania is in the EU, one source might be to include their Lithuanian loans in the cover for Pfandbriefe issuances under German law.)

The main question is whether there will be, in the future, times when the main commercial banks will want to rely so heavily on mortgage bonds that this overcollateralization will be burdensome. This probably will not be an issue in the near term, and once Lithuania is in the Eurozone, such funding could come from mortgage bonds issued under the laws of other countries that the mother banks of Lithuanian banks operate in.

Such a low loan-to-value (LTV) ratio as 70% could be quite burdensome. It is possible that, when the LTV is greater than 70%, the additional loan amount be originated as a top-up or second lien. However, this involves additional costs both at origination and later in servicing. The small potential benefit of such a requirement does not seem worth these additional costs. Thus, it is recommended that the law make it clear that all eligible loans can be included in the collateral, but the amount in excess of a 70% LTV does not count in the required cover.

What about the special supervision that the EU directive requires? There are at least three approaches possible in this regard. In the Czech Republic, there is currently no special supervision, beyond normal banking and securities commission supervision, specifically because of the extra cost involved. Lithuania could take this approach in the short-run and just expect to add some sort special supervision process when meeting the EU directive becomes more pressing.

Alternatively, the law could specify a system of private but state-supervised inspectors. Both Hungary and Slovakia have such systems.[24] Presumably, these private supervisory systems are lower cost than a fully state supervisory function of equal rigor, which is the third alternative. The author does not know what the relative costs of these approaches are

It is notable that Spain has a state-operated supervision process, but one that does not seem to involve the level of scrutiny applied in Germany, Denmark, or the outsourced systems in Hungary and Slovakia. Monthly inspection is made by the Bank of Spain to confirm that the relatively simple rules set by the law are adhered to.

The other area of uncertainty with respect to the operation of a mortgage bond law is that of the process of securing the rights of bondholders in the case of bankruptcy. As noted, the law in Spain relies on the general procedures for pledged assets in the case of bankruptcy. These are considered reliable with respect to securing assets for the repayment of the mortgage bonds, but not necessarily effective at assuring servicing of the mortgage securities during the period of receivership. The laws in Slovakia and the Czech Republic have similar provisions. In contrast, the laws that require that the loans be held by a legally separate entity, such as in Germany and Denmark, provide substantial protection throughout the life of the bonds.

Thus, there appear to be significant variations in this regard. Evaluation of the best approach in Lithuania must rely on a thorough understanding of the current procedures in the case of bank bankruptcy, and how they might need to be strengthened in this situation.

Bauspar Status in Lithuania

Recently, an interest in the Bauspar system re-appeared in Lithuania.[25] This renewal comes despite the development of an active market in regular mortgages at rates almost as low as in the BS systems of the early adopters (i.e., the BS loans in the Czech Republic, Hungary, and Slovakia are at 6%) and the offering of mortgage insurance that permits the purchase of a home with relatively little prior savings.[26]

A working group was set up in Parliament started with a draft law very similar to that adopted in the Czech Republic. The group has considered various versions of the key parameters, including the rate and maximum size of the annual bonus and the minimum term of the contract. In the version that was eventually registered in the Parliament in July, the law has been modified to set the minimum contract period to only 2 years. However, nothing was done to reduce the size of the premium. As will be discussed below, this change satisfies the complaint that the program can not have any positive effects in less than 5 years, but greatly reduces the size of the loan amounts and probably greatly increases the cost of the program.

The system in practice is quite complex. It involves a long-term contractual relationship between the saver and a specialized bank that does nothing other than such operations. The interests paid on the savings and the rate on the loan, as well as the term of the savings and of the loan, are fixed at the start. The term of the loan is usually somewhat longer than the term of the savings. However, the individual Bausparkasse (BS) has the right to delay the loan if there are not sufficient incoming savings to fund the loan. Because of this, the usual BS contract involves a complicated system for determining the priority of those seeking low-rate loans, depending on the period of the savings, steadiness of the savings and other factors.

Because all of these parameters are fixed at the outset, the attractiveness of the return on the savings or the rate of the loan, relative to market-rate alternatives, is uncertain. Because of that, the inflows into new or existing contracts may fall significantly if market rates on savings rise, and demands for "low-rate" loans may rise or fall according to market-rate alternatives.

Because of the general reluctance of the public to commit to such parameters several years in advance, and to tying up the savings as well, there are no examples in the world of such arrangements being popular in the absence of significant subsidy from the government. Moreover, the institutions themselves strongly lobby for subsidies that are big enough so that (1) savers are very likely to find the return attractive even if market interest rates rise by several percent and (2) borrowers will find the loan attractive even if market rates fall by several percent. Thus, the preference is for deep subsides, not shallow ones that might cause the system to go out of balance in the future.

What does it mean to "go out of balance?" A simple example, without any interest or subsidies, may provide the basic intuition. If there are 1000 new contracts signed each year, each to save LTL 2500 a year and with a minimum contract term of 5 years, then after 5 years, if everyone has made every savings payment on time and an additional 1000 savers signed contracts each year, there will be LTL 37.5 million in total cash in the BS.[27] But at the end of the 5th year, the first 1000 savers now want to take their money out and also get a loan which is repayable in equal installments over 5 years. Their total savings will now be LTL 12,500 each and their loan amounts will also be LTL 12,500 each. These first 1000 savers will want to withdraw a total of LTL 25 million from the BS. Where will this money come from?

At the start of the year, the BS has in its hands the accumulated savings of all of the savers, amounting to LTL 37.5 million. It will pay out the LTL 25 million and also receive an additional LTL 12.5 million in savings, for a net outflow of LTL 12.5 million (i.e., it will have only LTL 25 million left). At the start of the next year (7th year since the start), it needs to pay out another LTL 25 million to the next cohort of savers, but it receives another 12.5 million from the savers (including another 1000 new savers) and also gets back 20% of the LTL 12.5 million it loaned out in year 6, i.e., LTL 2.5 million. The net outflow of cash is LTL 10 million, dropping its cash to LTL 15 million.

If this continues for another 3 years, in year 11, the BS will have no cash in its vaults, but it will have LTL 37.5 million in loans outstanding, on which it receives LTL 12.5 million in repayments each year. Each year thereafter, the existing cohorts of savers put in LTL 12.5 million each year, the cohort reaching their 6th year takes out its savings of LTL 12.5 million, and there are LTL 12.5 million in loan repayments to re-lend to this cohort. Since the bank is receiving interest on the loans that is more than the rate it pays on the savings, it potentially may be able to cover its costs and make a profit out of this spread.

Table 13. A 5-Year Bauspar System in Balance in 2015 (by year of contract)

Inflows: Savings		**Inflows: Loan Repayments**	
2015 Contracts	1,000 x 2500 = 2.5 million	2009 Loans	1,000 x 2500 = 2.5 million
2014 Contracts	1,000 x 2500 = 2.5 million	2008 Loans	1,000 x 2500 = 2.5 million
2013 Contracts	1,000 x 2500 = 2.5 million	2007 Loans	1,000 x 2500 = 2.5 million
2012 Contracts	1,000 x 2500 = 2.5 million	2006 Loans	1,000 x 2500 = 2.5 million
2011 Contracts	1,000 x 2500 = 2.5 million	2005 Loans	1,000 x 2500 = 2.5 million
Total Savings in 2015	LTL 12.5 million	Total Loan Repayments in 2015	LTL 12.5 million

Outflows of Savings and Loans for the 2010 Contracts
Total Savings = 1,000 x 2500/year x 5 years = LTL 12.5 million
Total Loan Entitlement = 1,000 x 12.500 = LTL 12.5 million
Total Outflows = LTL 25 million

However, what if in the 12th year of operation, market interest rates on savings rise to a level higher than the amount paid (including the subsidy) by the BS? BS accounts are still attractive because of the low rate loan that will be available in 5 years, but not as attractive as before, and people may expect that market interest rates on loans will come down in the future. If the net effect is that only 500 savers start contracts in the 12th year, and each existing saver puts in only half as much as before, the net inflows from savers will be only LTL 6.25 million. There will still be the same LTL 12.5 million in repayments from earliest borrowers, so that there will be enough cash to repay the savings of the cohort in their 6th year, but only LTL 6.25 million to lend to them (half of what they have been promised).

This is why every Bauspar system needs a system for determining the priority of participants to getting a loan. And it is why the system will fail to provide loans at all if, for any reason, the supply of new savers drops off sharply. In fact, if the government at any time in the future eliminated the subsidy, there would be no new savers and no low-rate loans available to the savers who started in the last 5 years.

The System Proposed for Lithuania

The proposed Lithuanian Bauspar system can be summarized as follows:

Main Act:	Registered in the Seimas, expected to be considered in Fall session.
Regulation:	Ministry of Finance regulates and supervises the payment of premiums; Bank of Lithuania regulates/supervises the BSs, but follows conventional bank regulations, with no additional regulation imposed on liquidity management.
Yearly Premium Amount:	20% of savings and interest paid that year, up to LTL 500. Annual optimal savings is LTL 2500, or almost 4 times the average monthly net wage in 2001.
Minimum Saving Period:	2 years to get housing contractual loan (presumably at about 5%) if 50% of contracted sum is saved. (Because this provision is likely to be reset at 5 years once the impact of this provision is understood better, both the 2-year and the 5-year models will be analyzed.) Advance loans are available at a higher rate after 2 years (if a 5 year minimum contract). Saving for 2 (5) years required to cash the premium, even if no loan is taken.
Savings/Loan Differential:	The Bill (as of 4 July) specifies a maximum of a 2.5% difference between the contract interest on savings and the rate on the loan. (This spread is subject to some competitive pressures, and the rate on savings is usually raised if a saver does not take a loan.) The low rates on regular mortgages may cause the lending rates to be set at 4.5%, with savings rates as low as 2.0%.
Housing Purpose Required?	A "housing purpose" is required to withdraw the premium along with the savings. Loans are available only for housing purposes as demonstrated by invoices.

Other relevant aspects of the system include:

1. The interest and premium on savings are exempt from taxation (as are regular savings accounts);

2. Premiums are paid into the account within one or two months after the end of each calendar year, based on the savings during that calendar year

3. A market-rate housing loan can be taken immediately from Bauspar or the parent commercial bank, repayable by a low-rate loan (or advance bridge loan) from the Bauspar after 2 years of savings;

4. The parameters of the state premium are embedded in law, and Parliament must act to change them (*very important diversion from legislative tradition*).

NOTES

1 Housing and its Environment in Lithuania, National Report for the UN Conference on Human Settlements HABITAT II, Vilnius 1998

2 Housing Urban Development Foundation, Asta Paskeviciene, October 2002

3 Housing Urban Development Foundation, Asta Paskeviciene, October 2002

4 Household: is an association of people tied with relationship or other personal bonds who have common budget, have meals together and are accommodated in one housing unit. On person may also comprise a household.

5 Estimated based on the latest publication of Statistics Lithuania on population 2001. The ratio has been revised down.

6 'Progress for All: Common Country Assessment for Lithuania', United Nations, September 2001.

7 'A Survey of the Lithuanian Economy', Rinkos Institutas, 2001-02

8 Lithuanian Housing Strategy Program, Contemplated Programs Project, Douglas Diamond, 2002

9 This step can be taken further. There is much evidence, and common observation, that family costs are not proportional to family size.

10 In total, about 4000 soft-loans were financed between 1992 and 1997.

11 This state support was cut to half the insurance premium as of July 2001.

12 This step seems to be perceived differently by different people. It appears that the system was not supposed to work the way it had been, but with the mindset of municipalities, who had run such waiting lists for many years, this barrier was real. Moreover, in practice, lists were not regularly updated and notices would go out to a large group of people at the top of the list, many of whom had resolved their housing situation long ago. They would get a period of time to act and then another group of notices would go out, and so on. Thus, the switch to ignoring order on the list was significant.

13 An odd aspect of the situation is that insured loans, even the ones made when the LMIC was backed by a state guarantee, require the same full capital reserves as uninsured loans. This discourages use of the insurance.

14 This is a 40% reduction in the premium charged by the LMI, yet it is not clear that the risks borne by the LMIC have dropped much at all. It covers losses fully up to 25% of the initial principal plus 4 months of interest. In most cases, this loss would be more than 60% of the potential loss on a 95% LTV loan.

15 When the premium is borrowed, the risk rises and the maximum premium rises to 4.56%.

16 An additional reason for people not to register was that, in 2001, the soft loan program was not set until July, while registration had to be completed with the municipality by February 15, at which time the availability of soft loans was uncertain.

17 This is almost 1000 fewer than the number of soft loans "made" in 2001, a difference explained by the large number approved in December but not disbursed until 2002.

18 One other significant deterrent to the use of the LMIC cover is that their underwriting requirements with respect to repayment capacity are now stricter than general in the market.

19 Banks have a natural incentive to issue mortgage bonds if they are not too burdensome, due to the fact that, under the EU directive, such bonds require only a 10% risk weight when held by banks and are also eligible for more liberal limits on holdings by other regulated financial entities such as pension funds and insurance companies.

20 Of course, such bonds need an investor class which is interested in such medium-term fixed rate debt. Other Central European transition countries have developed such investors and it is likely that Lithuania will also. In addition, such bonds will have to be callable or the loans need to be covered by some sort of prepayment penalty.

21 The discussion here is based on the Spanish concept of "mortgage certificates" (cedulas hipotecarias), not the mortgage bonds. Both are described in the same law (2/1981). The main difference is that the certificates are automatically covered by all of the available mortgage collateral of the issuer. The bonds are secured by specific loans that are pledged. The decisions of banks to use the "certificates" approach rather than the "bonds" reflects the cost of recording the pledging and thus is an example of how, given a flexible law, banks will make the appropriate tradeoffs between greater security (and thus lower cost of funds) versus higher costs of operation.

22 The specifics, as well as advantages and disadvantages, of this approach are well spelled out in a document prepared by Moody's, "Spanish Cedulas Hipotecarias (Mortgage Certificates): Moody's Analytical Approach," April 1999.

23 To some extent, the restrictive rules in Germany and Denmark reflect that fact that the eligible loans are viewed as being very secure, and therefore good collateral, and so the emphasis is on also matching well the characteristics of the bonds. However, such a structure and emphasis is probably less useful in Lithuania. The collateral of mortgages on houses in Lithuania can not be viewed to be as reliable as that in Denmark, no matter what care is taken in formulating evaluations. The foreclosure system is untested in the context of large scale economic crisis, and the risk of political intervention in such circumstances is higher. Thus, it is not clear that a structure of finely tuned coverage and balance ratios, and strictly regulated evaluation procedures, is going to provide the invulnerable security being sought after. A reliance on overcollateralization makes more sense under these circumstances.

24 In Slovakia, a qualified private party, such as a bank or accountancy firm, must certify that the loan quality and overall coverage requirements are met. Their fees reflect both the cost of reviewing the files and the liability that they bear if they make errors in their task.

25 It appears to have been suggested by a bank seeking new products.

26 In fact, as discussed below, it is hard to see how a Bauspar system might improve access to housing credit.

27 After 5 years, the first cohort will have saved LTL 12.5 million in total, those in the second cohort LTL 10.0 million, the third cohort LTL 7.5 million, 4th cohort LTL 5.0 million and the 5th or most recent cohort LTL 2.5 million, for a total of LTL 37.5 million.

CHAPTER 6. HOUSING FINANCE IN LATVIA

by

Ilze Osa*

1. Macroeconomic Characteristics

Reforms accomplished in Latvia and integration in the European Union have left a positive impact on economic development of the country.[1] In the period from 1996 till 2003 Latvian gross domestic product (GDP) has grown on average by 6.1% annually. Among the other European countries only Ireland had higher growth rates in the same period of time.

Despite the slowdown of global economy since 2000, Latvian economy continues to develop at a speedy pace. In 2001 GDP in Latvia went up by 8%, in 2002 – by 6.4%, while in 2003 – by 7.5%. Also the year 2004 has started on a very positive note as the GDP has increased by 8.8% in the first quarter. According to the forecasts of the Ministry of Economics the GDP will go up by 7.5% in 2004.

High domestic demand (private consumption and investments) combined with the ability of Latvian enterprises to find new export markets was the reason for the growth over the past years. Manufacturing, construction, trade, commercial services and transport and communications had been the biggest contributors to the GDP growth.

Dynamic development continues in the construction sector. In 2002 the growth of this sector comprised 10.8%, while in 2003 the growth reached 13.7%. The building of residential houses, highways, roads and other objects goes on at a speedy pace. It is expected that construction sector will continue to grow rapidly also in the future in relation to the development of mortgage lending, increase of economic activity and capital investments, as well as implementation of projects financed by the EU funds.

High domestic demand promotes development of services, especially those concerning wholesale and retail trade (in 2002 this sector grew by 12.7%, while in 2003 the growth reached 11.3%). The dynamics of domestic demand is stable and ensured by the growth of income, stability of the financial system, widening of crediting facilities, accession to NATO and the EU and formation of positive future expectations. It is expected that the households' income increase and widening of consumption loans will foster further growth of domestic trade (especially non-food consumer goods) and other market services, nevertheless the growth rates will be slower than up to now, because of the market saturation. High growth

Economic growth in Latvia has been achieved in conditions of stable macroeconomic environment. The Bank of Latvia, having unofficially pegged the LVL to the SDR currency basket, is implementing

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[1] Ministry of Economics Republic of Latvia "Economic development of Latvia", 2004

a *de facto* policy of fixed national currency exchange rate. This reduces uncertainty, eliminates currency risk exposure and gives entrepreneurs a stable base for planning and price setting.

In accordance with the EU Accession Treaty the new member states will have to join also the European Monetary Union (EMU) and introduce the single currency, the euro, in the nearest future. This is the reason behind the expected changes in the monetary policy of Latvia. The strategy of the Bank of Latvia foresees pegging the lat to the euro and joining the European Exchange Rate Mechanism (ERM II) at the beginning of 2005 and participating in EMR II at least 2 years fulfilling the Maastricht criteria. The Bank of Latvia and the government have established January 1, 2007 as the deadline by which the criteria needed for introduction of the euro should be fulfilled. After the European Council will take a decision that Latvia is ready to participate in EMU the national currency in Latvia will be substituted by the euro and the Bank of Latvia will discontinue to implement an independent monetary policy. This according to the forecasts of the Bank of Latvia could happen at the beginning of 2008. Until then the LVL will remain the national currency of Latvia.

Latvia: Key Indicators of Economic Development

	2000	2001	2002	2003	2004 f
	(changes over the preceding year, %)				
GDP	6.9	8.0	6.4	7.5	7.5
Private consumption	6.3	7.3	7.4	8.6	8.0
Public consumption	-1.9	0.3	2.4	2.5	2.5
Total fixed capital formation	10.2	11.4	13.0	7.8	15.0
Exports	12.0	6.9	6.3	4.3	8.3
Imports	4.9	12.6	4.5	13.1	8.8
Consumer prices	2.6	2.5	1.9	2.9	5.5
	(in percent of GDP, unless indicated otherwise)				
General government budget fiscal balance	-2.6	-2.0	-2.3	-1.6	-2.1
Central government debt	12.2	13.8	13.3	13.4	14.9
Current account balance	-6.4	-9.0	-7.0	-8.6	-9.5
Foreign direct investment (flows)	5.3	2.0	4.2	3.3	4.5
Share of job seekers (% of economically active population, 15-64 years old)	14.6	13.3	12.1	10.7	10.0
Exchange rate of LVL against SDR (end of period)	0.7997	0.7997	0.7997	0.7997	0.7997

f – forecast

During the last four years the average consumer price inflation had been within the limits of 2-3%, reaching 2.9% in 2003. In the first half of 2004 inflation was higher than the price rise level of the previous years. In May 2004 compared to the same month of 2003 inflation increased by 6.2% or the average annual inflation reached 4.1%.

The reason behind higher inflation growth was the combination of several one-time factors, mainly the rise of administratively regulated prices, as well as high import prices in connection with the appreciation of the euro and changes related to the accession to the EU. Also, a temporary factor causing the rise of consumer prices was the "inflation expectations" based on the psychological effect and speculations on the expected price increase as Latvia moved closer to the accession to the EU. To curb inflation and private consumption the Bank of Latvia in March 2004 increased the refinancing rate by 0.5 percentage points and postponed the planned reduction of the reserve requirement till the end of 2004.

The goal of the fiscal policy implemented in Latvia is to secure a balanced economic growth and financial stability. Since 1996, with the exception of 1999 when the fiscal situation reflected the consequences of Russian financial crises, the fiscal deficit of the general government budget was lower than the identified in the Maastricht Treaty (3% of GDP). After Latvia's accession to the EU the compliance to the financial criteria of Maastricht Treaty will be consequently ensured.

One of the main economic development risks of Latvia is a relatively high current account deficit, caused by the high domestic demand, especially by the dynamic growth of investments. In 2003 the current account deficit equalled to 8.6% of GDP, exceeding by 1.6 percentage points the level of the preceding year. The main cause behind the deficit growth is the worsening of trade balance. Approximately a third of it is covered by the positive balance of services.

Since the deficit of the current account is basically covered by foreign direct investments and long-term loans, the level of deficit at the moment is not considered as critical. Net foreign reserves of the Bank of Latvia are growing and fully cover the reserve money.

It is anticipated that growth of exports promoted by structural reforms will bring down the current account deficit in the medium-term. However, the demand for imports will remain relatively high due to the further modernization and the growth of the openness of the economy. It should be noted that after the accession to the euro zone risks related to negative current account deficit (risk of currency crises) will almost fully disappear as stability of the currency and keeping of foreign currency reserves will become the competence of the European Central Bank.

Economic growth stimulates also the growth of wages. Net wages in 2003 in comparison with 1996 had gone up by 89% and by 10.9% exceeded the level of 2002. During this period inflation had increased by 51%, while in 2003 inflation grew by 2.9%. The real income of employees from 1996 till 2003 had grown by 25%, whereas in 2003 the growth reached as much as 7.8%. During the previous two years real wage growth had increased faster, which was fostered also by the growth of the minimum salary. Yet, growth of income is very uneven, polarization of society in terms of income is increasing and the number of poor people in the country is relatively high. Growth of old age pensions is slower than the growth of the income of employees. Gini index, which shows the inequality level of the welfare, has gone up from 0.30 in 1996 to 0.34 in 2002.

The employment and unemployment indicators are gradually improving. However, it should be noted that the improvement of these indicators had been mainly reached at the expense of productivity and, to a lesser extent, due to the higher number of employed people. In 2003 the number of employed persons in the age group between 15 and 64 years had grown only by 6% comparing to 1996. However, in nearly all sectors of national economy there is a tendency that growth does not have a major impact on employment. With the development and strengthening of the private sector also competition becomes stronger forcing companies to look for ways of decreasing costs. With the improvement of management one of the main cost items to be downsized are labour costs, which often results in reduction of the number of employees. These processes are objectively determined for the Latvian economy given its generally low level of productivity. Therefore, future growth will be mostly based on increase of productivity rather than growth of the number of employees.

Economic activity of people (participation in the labour market) is a little bit lower than on average in the EU, while economic activity of women already now has exceeded the average indicators in the EU.

The number of job seekers in the age group between 15 and 64 years had decreased substantially (from 20.5% in 1996 to 10.7% in 2003). However, great differences remain between unemployment rates in different regions and cities. The lowest unemployment is in the Riga region, whereas the highest – in Latgale. Employment promotion measures and increase of economic activity in many rural areas until now have not resulted in positive changes. The most difficult situation remains in Latgale where unemployment in some regions exceeds 20% of the economically active population (the average unemployment rate registered at the end of 2003 was 8.6%, while the real unemployment (the share of job seekers) reached 10.7%). Also the GDP per capita in Latgale is the lowest in the country, being twice as lower than the average in Latvia.

The economic growth potential is best characterized by the growth of investment. From 1996 till 2003 the gross fixed capital formation annually went up on average by 17%. Investment grew especially rapidly during 1996-1998, fostered by privatisation. Also now despite the completion of mass privatisation total fixed capital formation continues increasing every year at a rather fast rate.

Growth of investment and the share of investment in GDP in Latvia are one the highest among the new EU member states. Investments are promoted by several factors, including stable macroeconomic environment, inflow of foreign investments, reduction of interest rates on loans and strengthening of the banking sector, increase of general economic activity and formation of positive future expectations, etc.

The reforms carried out in the previous decade have strengthened the private sector. Good macroeconomic conditions for the further development have been created and the business environment is improving, too. Accession to the EU will have a particularly positive impact on Latvian economy, strengthening confidence that the growth will be sustainable also in the coming years. If there are no external shocks the annual GDP growth can be expected by 6-8% in the medium-term.

2. Housing Sector Overview

As Figure shows since 1991, construction of new buildings has dwindled to a minimum, and many half-built buildings have been abandoned, especially in Riga. The only buildings built now are those with private investments.

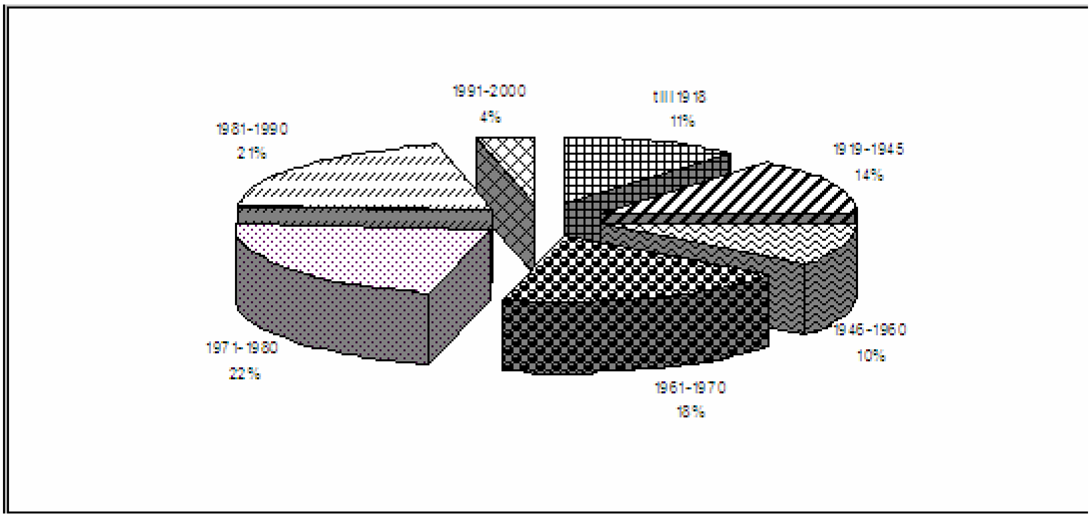
There are problems with heat inefficiency in dwellings built before 1970.

At the end of 2003 the total floor space of the housing stock of Latvia amounted to 55.4 mln m^2; of these 16.5 mln m^2 or 30% were in the city of Riga, according to the Central Statistical Bureau.

Approximately two thirds of the total housing stocks are located in urban areas and one third is in rural area.

One of the main indicators of the housing stock is the total floor space on average per resident inhabitant; it was 19.2 m^2 in 1990, 22.6 m^2 in 2000 and 23.9m^2 in 2003.

Housing Quality



Latvia's housing stock

Apartments with public utilities at the end of 2001 (% of total apartments)

	state	Of which	
		cities	rural
Apartments with public utilities:			
Piped water	94.3	96.4	79.4
Sewerage	93.5	95.7	77.8
Central heating	84.3	88.6	54.4
Fixed bath or shower	84.9	88.1	62.5
Hot water supply	78.1	84.2	35.4
Gas supply	85.7	87.5	73.2

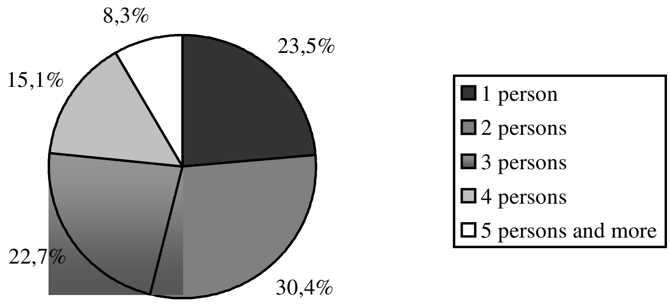
Basic indicators of the housing stock[1]

(at end of the year, millions m^2 of the total floor space)

	1990	1995	2000	2001	2002	2003
Total	52..9	52.7	53.4	53.5	54.9	55.4
of which :						
Public sector	36.6	26.2	12.8	11.0	10.2	9.2
Private sector	16.3	26.5	40.6	42.5	44.7	46.2
On average per inhabitant, m²	19.2	21.4	22.6	22.8	23.6	23.9
Urban housing stock -	33.8	34.1	34.7	34.8	35.7	36.2
of which :						

Public sector	26.2	22.3	10.1	8.4	7.8	7.0
Private sector	7.6	11.8	24.6	26.4	27.9	29.2
On average per urban inhabitant, m²	18.3	20.1	21.5	21.8	22.6	23.0
Rural housing stock-	19.1	18.6	18.7	18.7	19.2	19.2
of which :						
Public sector	10.4	3.9	2.7	2.6	2.4	2.2
Private sector	8.7	14.7	16.0	16.1	16.8	17.0
On average per rural inhabitant, m²	23.3	24.3	25.0	24.8	25.6	25.8

Distribution of households by size



Source: CSB, Household Budget Survey. Note: in 2002, in %

Table 2. Dwellings by size

Floor space	Total housing stock
Up to 20m^2	1.32
20-40 m^2	25.3
40-60 m^2	50.14
60-80 m^2	19.47
80-100 m^2	2.54
>100 m^2	1.23
	100%

Housing and Denationalization

As a result of the denationalization of house ownership and privatization of local government-owned residential buildings the ownership structure of the housing stock has changed. At the end of 1990 the share of the private sector in the housing stock was 31% but by the end of 2003 it had increased to 83%.

In the period between 1992 and April 2003 57 thsd dwellings were privatized in Riga according to the revised data of the Riga City Council. According to the results of the survey "Private tenement houses" conducted by the CSB, 27 thsd tenants lived in denationalized houses in Riga; of these, 20 thsd tenants had been living there before the denationalization of the house.

Housing and Land Privatisation

The privatisation process in Latvia began in 1991 and it is presently in the final stage. Its objective is to reduce State participation in the economy and to create a favourable environment for the development of private capital and initiative[2]. According to the Central Statistical Bureau, about 80 % of Latvian housing will be private property by the end of the privatisation process and municipalities will maintain only 20% of the housing as rental or social housing.

The privatisation process is performed by individual privatisation commissions- established in each municipality- and co-ordinated by the Central Apartment Housing Privatisation Commission. Privatisation certificates[3] for the privatisation of apartments have been issued to private individuals based on age, working history, deportation and other factors. Now this institution is abolished and State Agency "Housing Agency"accomplishes the privatization of state dwelling houses in accordance with the Law "On Privatization of State and Municipal Housing".

There are two types of housing privatisation in Latvia which are the Regular or Full Privatisation and the Accelerated Privatisation. The latter is a temporary stage of the Full Privatisation. In the Regular or Full Privatisation, the entire building is privatised and registered in the Land Book and each apartment, with its respective joint ownership of common areas and land, is registered as a private property in the Land Book. In the Accelerated Privatisation, only the apartment is privatised without any assigned portion of the common areas and land. Ownership of the apartment is only registered in the Cadastre. Once the house is fully privatised, ownership titles of individual apartments and their respective joint ownership of the common areas and land are registered in the Land Book.

According to the Law, "On Privatisation of State and Municipal Apartment Houses", by April 30, 2002, there have been 25 673 state and municipal apartment houses prepared and assigned for privatisation[4]. These apartment houses represent 480,893 apartments, which equals 96.17% of the total number of flats in Latvia. Privatisation notifications have been sent to 287,346 tenants[5]. There were 150,127 notifications sent, upon the conclusion of purchase agreements, to individuals who had privatised their flats prior to the privatisation of the entire building, and 193,547 flats were assigned for privatisation before privatisation of the building[6].

3. Housing Finance Market and System

Compared with 2002, the total value of real estate sales transactions in 2003 rose by 38% and was LVL 255 million.

Value of real estate sales transactions in 2003

Kind of real estate	Number of transactions	Value of transactions, mln LVL	Average value per transaction, thsd LVL
Total	**21.9**	**254.9**	**11.6**
of which:			
Buildings with land	4.8	97.9	20.3
Buildings	0.5	18.3	33.9
Dwellings and uninhabitable premises	8.9	64.2	7.2
Land	7.7	74.5	9.7

Mortgage Loan Industry

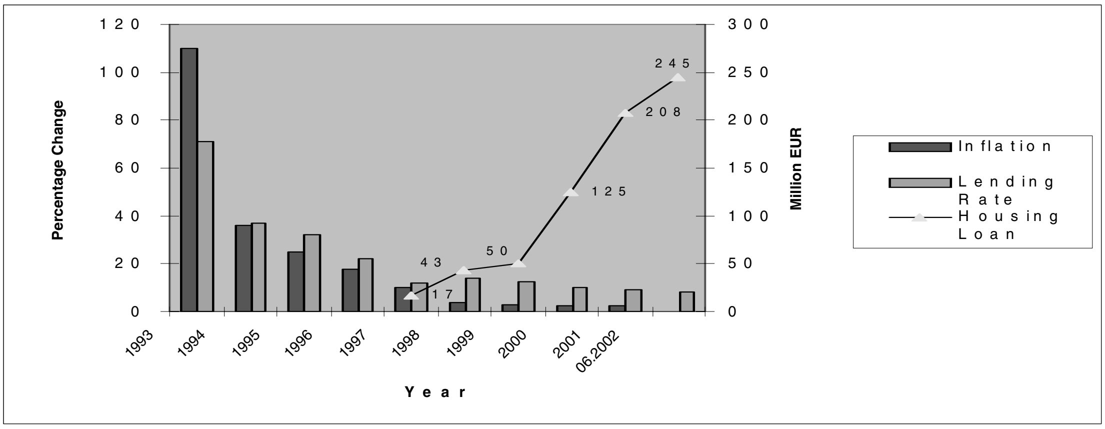
The recent developments in the mortgage loan industry include the decrease of lending rates and the increase of loan maturities and loan-to-value ratios. The main factor that prompted the foregoing developments is that the majority of individuals' incomes are insufficient to comply with existing loan requirements.

Loan terms were typically quite short, but banks have recently started to offer 20 to 40 year mortgage loans. As well, many financial institutions offer fixed and floating interest rates. In the past, banks required down payments that were as high as 30 to 40% of the property value but the recent trend has been towards lower requirements, such as 10 to 20%.

The range of mortgage products is limited in Latvia, which is the case in most transition economies. Loans can be denominated in Lats or in foreign currency.

Between 1993 and 1999, the volume of mortgage lending increased dramatically. The foregoing can be attributed to lower inflation, macroeconomic stability and growing consumer confidence[7] (Figure below).

Mortgage Volumes and Lending Rates (1993-1999)



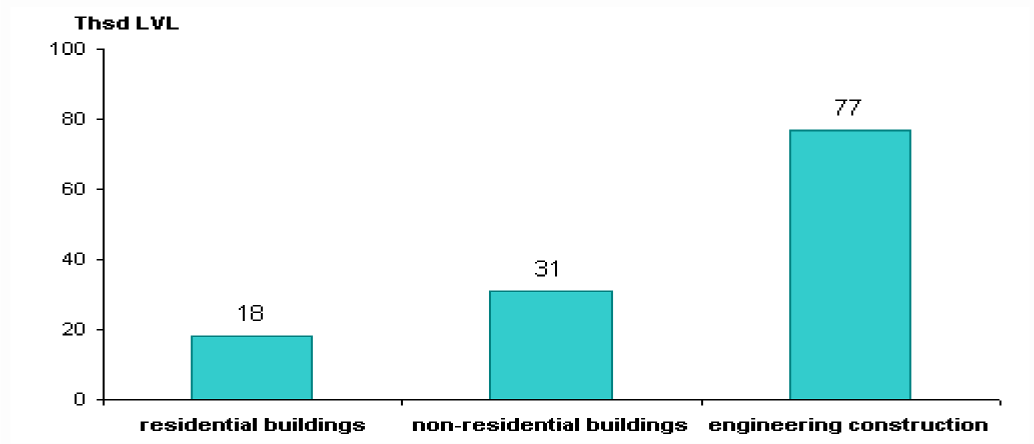
In 1998, the Latvian Parliament adopted the Law on Mortgage Bonds, which provides the legal basis for the issuance of mortgage bonds. Mortgage bonds in Latvia are typically liquid and secure; therefore they are highly demanded by investors.

The Bank of Latvia uses mortgage bonds in their monetary operations, which ensures the bonds' liquidity. Furthermore, all mortgage bond issues are quoted on the Official List of the Riga Stock Exchange. Mortgage bonds issued by the Latvian Mortgage and Land Bank have a rating of A3 (Moody's) which was assigned in November 2001 and confirmed in April 2002.

Despite the favourable developments-in mortgage conditions-to borrowers, banks still consider long-term mortgage lending to be risky due to the low solvency of the majority of residents in Latvia.

The major obstacles for sound growth of the mortgage loan industry in Latvia are the low borrowing capacity of the population and a mental resistance to borrow as a result of the Soviet era, where the majority of investments were financed through personal savings.

Average value per transaction in buildings with land

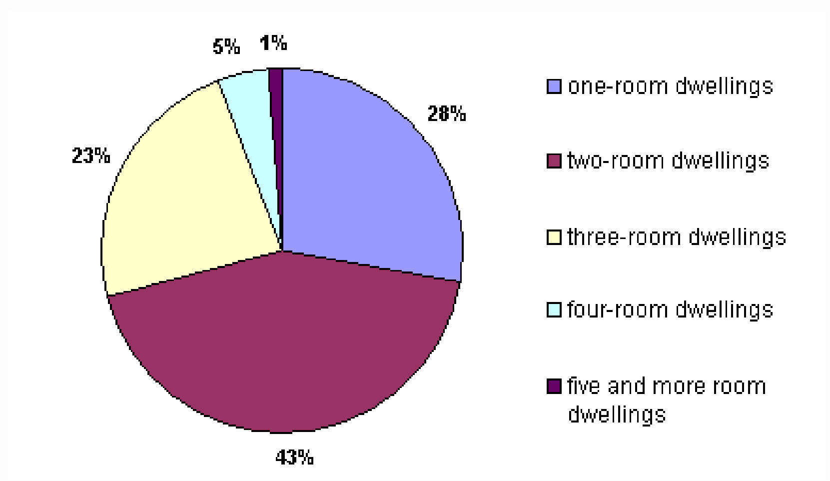


Concerning sales transactions in residential buildings with land the average value of buildings accounted for 79% of the total cadastre value but the value of land represented 21%. By contrast, the value of buildings in sales transactions in uninhabitable premises with land represented on average 57% of the total cadastre value but the value of land accounted for 43%.

The highest average value per sales transaction in residential buildings with land was observed in Riga (LVL 53 thsd), followed by Jūrmala (LVL 43 thsd) and Liepāja (LVL 25 thsd).

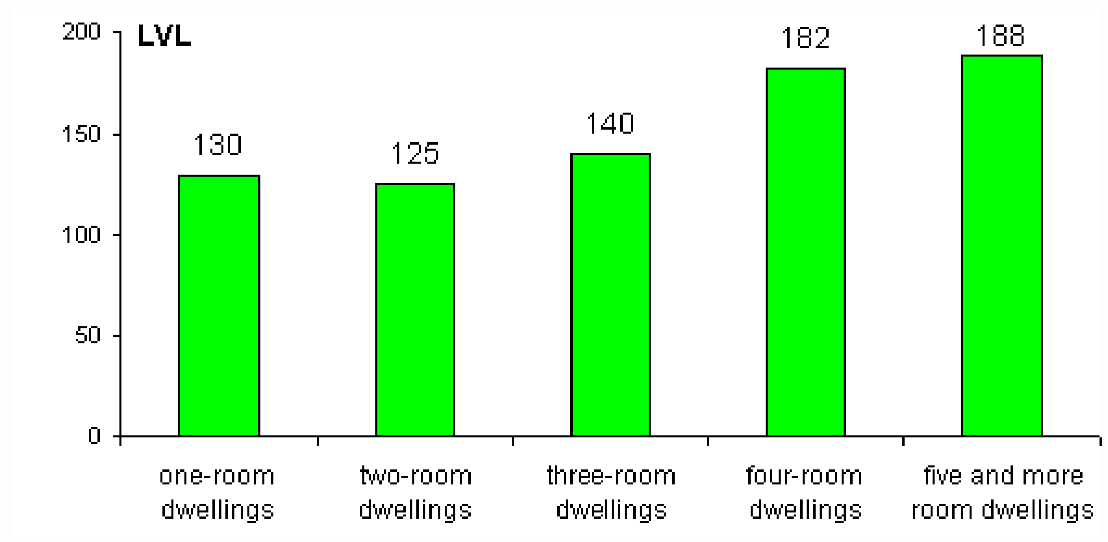
Along with arranging legal relations in real estate trade, the sales volume of buildings (without land) is gradually decreasing. The total value of sales transactions in buildings in 2003 equalled LVL 18 million or 7% of the total amount of real estate transactions.

Dwellings sold in Latvia in 2003 by the number of rooms

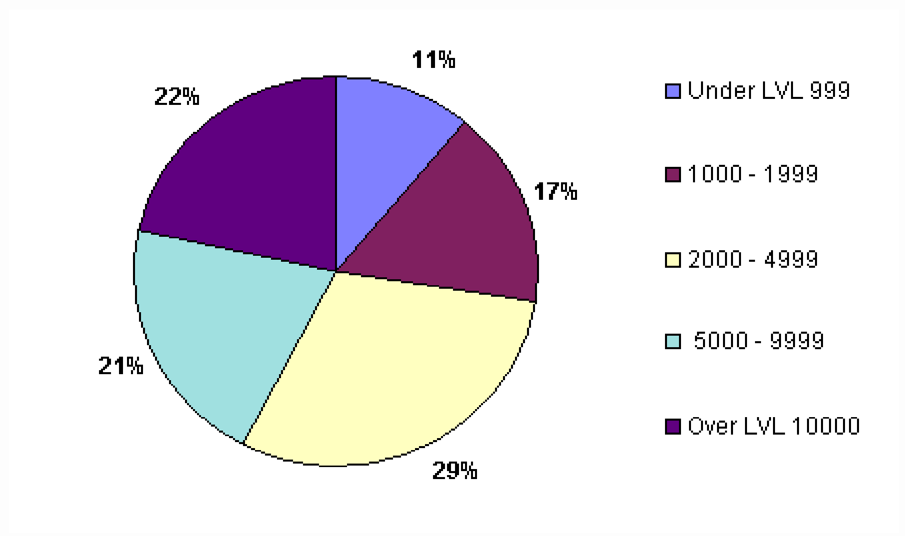


On average there were 2.1 rooms per one dwelling sold with the total floor space equalling 51 square metres.

The price per square metre of the total floor space of dwellings sold in Latvia



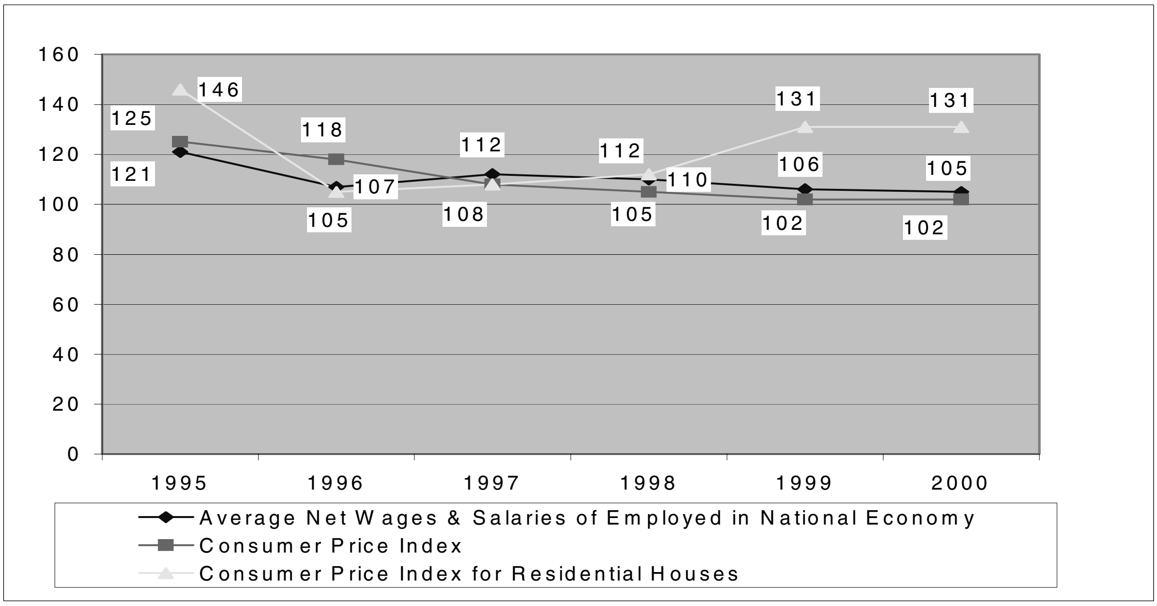
Dwellings sold in 2003 by value of transaction



The average price per dwelling in Latvian cities and towns where at least 50 dwellings were sold in 2003[8]

Cities and towns	Price per dwelling, thsd LVL	Average price per square metre of the total floor space [of the dwelling]
Riga	11.5	220
Jurmala	11.3	200
Ogre	7.3	144
Jelgava	6.6	130
Valmiera	6.0	107
Salaspils	5.5	111
Sigulda	5.3	108
Olaine	4.4	94
Cesis	4.1	82
Daugavpils	3.3	66
Liepāja	2.8	51
Talsi	2.7	66
Liepaja	2.7	54
Ventspils	2.7	55
Tukums	2.7	54
Saldus	2.3	48
Madona	2.2	45
Rezekne	2.1	44
Dobele	2.1	35
Aizkraukle	1.9	43
Kuldiga	1.7	38
Alūksne	1.2	25
Gulbene	1.1	22
Preiļi	1.0	23
Jekabpils	0.9	17
Balvi	0.8	18
Livani	0.4	9

Construction Cost Index



Source: Central Statistical Bureau of Latvia, 2002; 2001

In 2001, merely 4% of all construction in Latvia was construction of housing which was mainly financed by residents. In the same year, the number of construction permits issued to build one-apartment houses (or to reconstruct an existing house) rose to 1606 from 1507 permits in the previous year[9]. Furthermore, there were 34 permits issued for construction of two or more apartment houses in 2001, 16 of which were in Riga[10]. As well, real estate developers have announced plans to construct at least 15 single family house villages in suburbs of Riga with a living area of about 200,000 m^2.

There are a number of factors that impede the construction of residential buildings. Firstly, construction costs are high as compared to the affordability of individuals. As a result, a disproportionate number of luxury houses are built to target individuals with high income. Secondly, renting out housing is not considered a business activity and finally, support from the State is inadequate; however, it is investigating measures to finance the construction of residential buildings. In particular, housing for middle income people. The State is also exploring the creation of incentives to encourage individuals to invest in housing. One of the options is a guarantee system to facilitate and stimulate construction and renovation of housing.

For the moment, government resources for housing will be mainly used to create a social housing fund with small, cheap apartments for urgent cases and specially adapted flats for senior citizens and disabled persons.

4. Housing Policy

4.1. Government Policy for Own Housing

Housing policy since 2003 is framed by The Ministry of Regional Development and Local Governments. The issues of construction in Latvia since 2003 are regulated by the Ministry of Economics. The Ministry of the Environment is responsible for the development of policy from the perspective of environmental concerns. The State Agency “Housing Agency” (established in November of 2002) is responsible for the enforcement of housing policy.

In framing and enforcing policies, the Ministry of Regional Development and Local Government liaises with the Union of Latvian Municipalities, the Association of the Large Cities and the Housing Development Advisory Board.

The State Agency "Housing Agency" is a government institution supervised by the Ministry for Regional Development and Local Governments. The overall goal of the "Housing Agency" is to realize a corporate national policy in the sphere of housing. The State Agency "Housing Agency" was formed by the decision of Cabinet of Ministers on October 1, 2002. The mission of the "Housing Agency" is to enhance the quality of housing, its affordability and opportunities for choice.

The Government has issued a number of housing policy papers. They concern not only public administration institutions and municipalities but also every member of public who wants or needs to improve the housing conditions by means of purchasing new housing, renovating existing one, or developing the neighborhood. This information is intended to disseminate information on fundamental principles and anticipated development trends of the national housing policy among the stakeholders and general public.

According to the Latvia Concept of Housing Policy, which was approved in 1996, housing development in Latvia consists of specific economic, social and housing stock goals.

The social goal of housing development is to provide individuals with the possibility to choose and improve their housing situation. As well, to continue to make social housing available for low-income families.

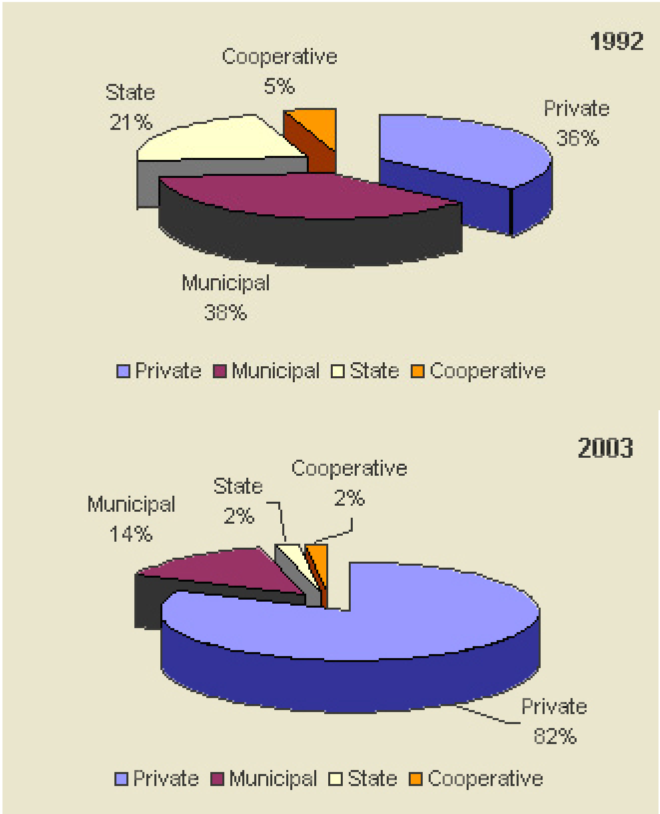
The Concept Paper also lists following tasks, which are equally important:

- Development and maintenance single national housing registry,
- Housing assistance to disadvantaged groups of population in form of municipal homes and housing adapted for people with special needs,
- Establishment of low interest long-term mortgage system for housing development,
- Compensation system for limitations on exercising of ownership in protected areas.

Since 1996 some of the objectives have already been accomplished - legislative framework is established and housing assistance and tenure rights are secured.

The privatization process of state and municipality-owned housing is nearing an end. Picture below shows change in ownership type resulting from processes of real estate denationalization from 1991 and privatization from 1995.

Distribution of housing by type of ownership in 1992 and 2003



Housing policy is a process of gradual development and every stage of development features different problems. Thus, as a direct result from privatization process and private ownership of apartment buildings the following new issues emerged: building management of shared property, including availability of resources for development.

Finally, the Government's housing stock goals are to increase the supply of family houses and multi-apartment buildings with fewer stories and to continue the privatisation process in order to increase the number of apartments inhabited by apartment owners.

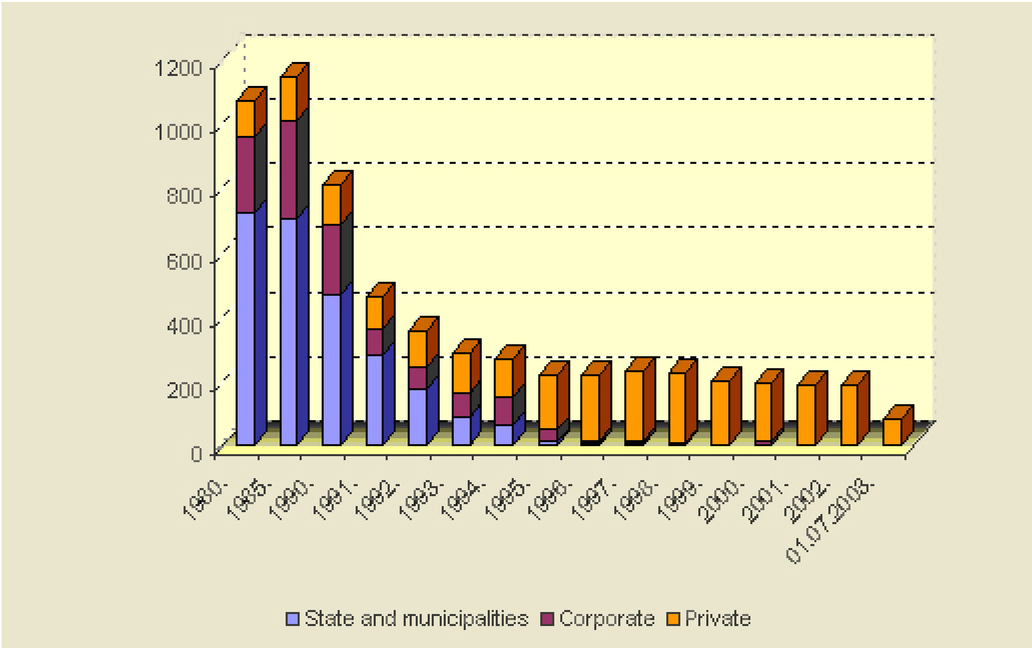
Concept Paper on Long-term Low Interest Rate Mortgage System For Housing Development

Recent past has seen the gradual decline in new housing building volumes. At the same time there are many families and individuals willing to build new homes or improve existing ones.

Several commercial banks in Latvia offer commercial mortgages and loans for a period up to 7 years at an annual interest rate ranging from 12 to 24%. To address the issue on the national level the Cabinet of Ministers approved the *Concept Paper On Mortgage System For Housing Development* on 19 November 1997.

The Concept Paper foresees establishment of efficient and feasible commercial mortgage system to facilitate housing development in urban, suburban and rural areas through low interest rate and agreeable repayment periods. In addition to mobilization of resources for development the capitalization of savings will be promoted. Mortgage system cannot develop without an appropriate legislative framework. Currently the framework consists of Civil Law, Land Register Law and Civil Procedure Code, which all together represent an adequate legal base for all mortgage-related issues. Main problem encountered in the process of mortgage system introduction is excessively high price of available credit resources and comparatively short term of availability.

Housing construction in Latvia



The Concept paper declares following core principles:

(a) Priority areas for long-term mortgaging:

- Purchase of dwelling houses and apartments;

- Construction of new housing, with special encouragement for family homes and detached and semidetached developments;

- Renovation and upgrade of state, municipal and private housing, including adaptation for people with specials needs;

- Insulation.

(b) Priority reconstruction, upgrade and insulation works:

- Roof repairs and reconstruction of flat roofs;

- Energy saving measures – outer insulation with façade refurbishment, modernization of the heating system, window replacement and double-glazing;

- Redecoration of shared facilities – stairs and entrances, development of basement space;

- Re-designing of the dormitory type houses into modern apartment houses;

- All works to adapt housing for people with special needs;

(c) Performance of national target programmes:

- State guarantee as a collateral for mortgage,

- State guarantee for commercial mortgages,

- Subsidies towards the mortgage interest,

- Partial mortgage subsidy from national budget resources,

- Tax relief.

Housing Development Mortgage Programme, Stages I and II

The supply of the population of Latvia with housing, both in terms of quantity and quality, is not up to par with standards of the European Union. Furthermore, the floor space per dweller practically has not essentially changed during last five years, though the construction rates lately have grown significantly.

Significant factor is lack of state funding for housing development. Mainly funding derives from the private resources and commercial loans. Estimated 1.6 to 3.7 billion Lats have to be invested during a five-year period in order to reach the current EU level in housing sector.

To implement the objectives and reach targets as set in the *Latvian Housing Policy Concept Paper* and *Concept Paper On Housing Development Mortgage Programme*, and to address the complicated issue of inadequate funding, the work on drafting the *Housing Development Mortgage Programme* was started. Mortgage and Land Bank of Latvia was involved in this process. Stage I of the Housing Development Loan Programme was approved by the Cabinet of Ministers on 13 June 2000.

Financial resources allocated for the implementation of the Housing Development Mortgage Programme are managed by Mortgage and Land Bank of Latvia. Mortgage and Land Bank of Latvia re-finances 80% per mortgage issued by commercial bank in accordance with the provisions of this programme, thus providing long-term mortgages for relatively low interest rate. The underlying key principle is to encourage the private homeowners to invest their own savings in reconstruction and renovation of their houses, as well as to build new housing and complete buildings under construction.

Initially it was planned to start with total amount of 20 million Lats and to issue mortgages, covering all regions of Latvia, distributed between priority areas as follows:

120 - to renovate block apartment houses,

3650 - to renovate and redecorate apartments,

1100 - to purchase and renovate apartments,

480 - to complete family homes under construction.

The objective of the Programme is:

- to meet the needs of the population for affordable housing, infrastructure and service facilities;

- to create economically viable conditions to attract private savings for the development of housing, to create mortgage system affordable in terms of interest rate and recovery period;

- to facilitate development of the housing market;

- to facilitate the development of construction sector, thus contributing to national economy and, specifically, to development of construction material manufacturing industry, construction industry and related industries;

- to develop mortgage system and relevant financial market instruments.

The Programme consists of two stages, which are implemented through pilot programmes. Stage I includes two sub-programmes: *Housing Project*, which involved development of legislation, institutional development and the development of the system of guarantees, and the *Housing Development Mortgage Pilot programme*.

For each of the pilot programmes funding from various financial institutions is attracted, including the plans to receive state guarantees.

The objective of Stage I of the Housing Development Loan Programme is:

- to evaluate current hindrances to mortgage development and success rate of the sponsored trial ,

- to perform precise estimation of the funding needs for housing development,

- to facilitate upgrading and expansion of the existing housing,

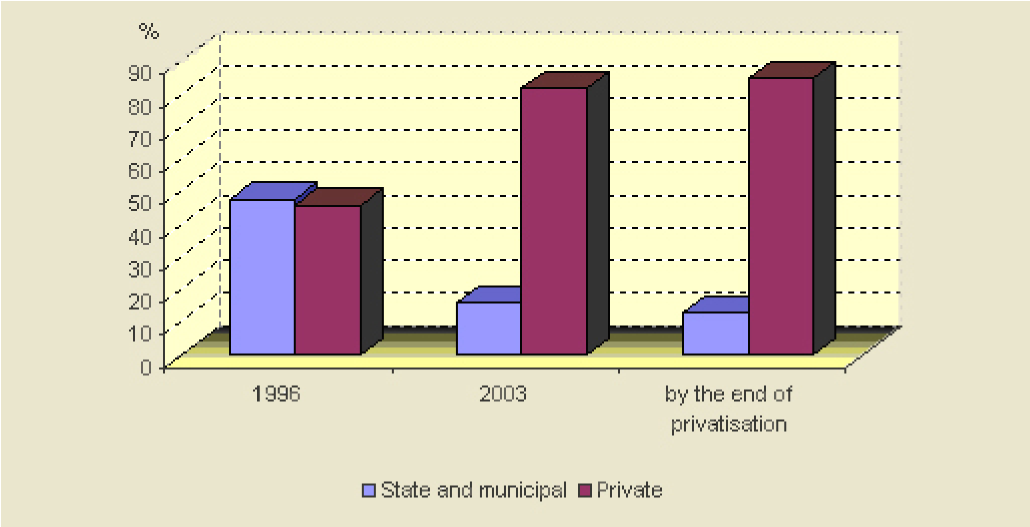
- to provide availability of mortgages with annual interest rate of 9% ,

- to assess the necessity for the state and municipality guarantee schemes and a state co-financing scheme.

Concept paper on legislative and institutional framework on development of housing and tenure

The development of the free market economy in Latvia has brought along principal change in the structure of the housing ownership, while effective legislation and practice fall short on successfully regulating current cases. Privatization of the state and municipality-owned housing and denationalization of buildings has already caused significant changes, which are expected to result in the following distribution between the types of ownership:

Change in the housing structure by ownership type



As the share of privately owned housing increases annually, the Government assessed the tenancy-related legislation and enforcement. The conclusion was that maximum admissible rent, established by municipalities, only partially covers the costs of building management and maintenance, which accelerates overall deterioration of housing. Furthermore, the need for social assistance for accommodation by far exceeds the possibilities to furnish it.

The general principles of housing management are stipulated only in the Civil Law of Latvia, while the management of privatized housing is regulated by the Law on Ownership of Housing, which permits selecting freely the type of management for joint property. Currently there are several types of management of housing: co-operative of apartment owners', non-profit organizations, limited liability companies or shareholding companies, as well as collective agreement of apartment owners; in the cities housing is managed by house management offices or individual house managers. The majority of the house managers do not have professional training or background, which causes problems not only with specific management issues but also with possible funding and mortgages.

Failure to make necessary amendments to laws and other legislative acts can lead to the following consequences:

- further deterioration in quality and a considerable reduction of suitable housing resources,

- municipalities will be not able to supply municipal housing in mandatory cases, due to decrease in available housing resources, resulting from privatization and insufficient building development,

- not viable and unprofessional management of housing will continue to produce deterioration of the housing quality and squandering of funding, eventually requiring significant investments in renovation of the housing.

In order to harmonize the legislation with the principles of national housing policy and to optimise institutional framework, and to meet international commitments, the Building Department of the Ministry of Environment and Regional Development developed *Concept document on the improvement of legislation and institutional structure relating to housing and tenure*, approved by the Cabinet of Ministers on 4 September 2001. It is necessary to revise relevant legislation to determine the sharing of responsibilities between the government, municipality, individuals and incorporations on housing, to activate housing market and to ensure quality maintenance of housing.

The need for this Concept Document was determined also by the involvement of Latvia in the activities of the United Nations Centre for Human Settlements and participation in the United Nations World Conference on Human Settlements Habitat II City Summit, which took place in 1996 in Istanbul.

Legislation

The key laws regulating housing-related issues are:

- Law On Restitution of Lawful rights to the Real Estate, adopted by the Supreme Council on October 30, 1991;

- Law On Denationalization of Real Estate in the Republic of Latvia, adopted by the Supreme Council on October 30, 1991;

- Law On the Rent of Housing, adopted by the Supreme Council on February 16, 1993;

- Law On Privatization of State and Municipality-Owned Housing, adopted by the Saeima on 21 June 1995;

- Law On the Ownership of Housing, adopted by the Saeima on 28 September 1995;

- Law On Social Apartments and Social Homes, adopted by the Saeima on 12 June 1997;

- Law on Cooperative Societies, adopted by the Saeima on 5 February 1998;

- Law On Municipal Housing Assistance, adopted by the Saeima on 6 December, 2001;

- Law On Construction, adopted by the Saeima on 10 August 1995;

- Law On Land Register, adopted by the Cabinet of Ministers on 22 December 1937 (in force since 05 April 1993);

- Law On Cooperative Dwellings, adopted by Supreme Council on 4 December 1991;

- Law On Registration of Real Estate in Land Register, adopted by Saeima on 30 January 1997;

- Cabinet of ministers Regulation No. 561 "The Auction Procedure on Renting State-Owned Housing", issued by the Cabinet on 27 December, 2001, pursuant to the amendment to the Law On the Rent of Housing;

- Cabinet Regulation No. 45 "Methodology for Calculation of Management Costs, Included in the Rental Charge for Dwelling Premises", issued by the Cabinet of Ministers on 29 January, 2002, pursuant to the amendment to the Law On the Rental of Dwelling Premises;

- Cabinet Regulation No. 133 "Procedure of the settlement for services and utilities between the Tenant, the Landlord and service provider", issued by the Cabinet of Ministers on 26 March, 2002, pursuant to the amendment to the Law On the Rent of Housing;

- Cabinet Regulation No. 112 “Regulations On General Construction”, issued by the Cabinet of Ministers on 1 April 1997.

In accordance with the provisions of the Accession Partnership, the Government of Latvia has prepared, with the European Commission, Directorate-General for Employment and Social Affairs, and signed a Joint Inclusion Memorandum with the purpose of preparing the country for full participation in the open method of coordination on social inclusion upon accession. The Memorandum outlines the principal challenges in relation to tackling poverty and social exclusion, presents the major policy measures taken by Latvia in the light of the agreement to start translating the EU's common objectives into national policies and identifies the key policy issues for future monitoring and policy review. Progress in implementing such policies will be assessed in the context of the EU social inclusion process, whose goal is to make a significant impact on the eradication of poverty in Europe by 2010. A significant precondition for reducing the risk of social exclusion is the availability of suitable housing. Low-income levels and comparatively high rental and utility charges are the cause of the majority of housing related problems.

Housing taxes

Tax on imputed rent	Mortgage related interest relief	Indirect taxes on new homes in %
The tax on imputed rent will adjust until 2007. This tax is calculated only for the land under dwelling, not dwelling as property	The tax is already included in acquisition of building materials, costs of construction etc	18

4.2. National Policies and Programmes affecting Urban Development in Latvia

Latvian national urban policy is developing. However, a number of national economic, social and environmental policies and programs shape the framework within which urban local governments address specific local issues. Central government institutions play a leading part in defining important sectoral priorities (economic, social, for example) and in designing programs levelling off territorial inequalities. The urban agenda is not a political priority and policy reforms have pushed regional development approaches ahead. The overarching policies for Latvia’s development are articulated in The National Spatial Plan, The National Development Plan and more than 20 national and sectoral development programmes. Line ministries and newly-established Regional Councils ensure the coordination of regional development planning and support measures in accordance with basic principles identified in regional development planning documents at the national and regional level.

Economic policies

The most important national economic policies are set out in *The National Employment Plan (NEP).* NEP for 2003 contains a list of 56 activities, mainly concentrating on the improvement of employable skills and support for business activity. The employment promotion measures are closely linked with the implementation of the *Joint Assessment of Employment Priorities in Latvia* signed by Latvia and the European Commission and the Development Plan for 2004-2006. The funding of activities is linked with the European Social Fund, which is the main EU financial instrument for the development of human resources and improvement of the labour markets. *The Long-term Economic Strategy of Latvia* defines the basic positions of the economic policy. The aim of the long-term development strategy of Latvia is to ensure the transition from a labour-intensive economy to a knowledge economy and in this way to reach the average per capita GDP levels of the EU member states in the next 20-30 years (Ministry of Economic Affairs , 2003).[11]

Social policies

Latvia has started several important reforms to address social issues. A state-funded second-level pension scheme was launched on July 1 2001; the scheme is one of the most progressive in the countries of transition. The pension age will be gradually increased to 62 years both for men and women by the middle of 2008. Better mechanisms of providing and channelling social assistance are being introduced within the scope of the reform of the welfare system to ensure the efficient integration of people in social and economic life and to provide better social protection. The *Joint Inclusion Memorandum* has been signed with the European Commission. The memorandum stipulates priority areas and activities to reduce poverty and social exclusion, with a special concentration on groups at risk of social exclusion such as disabled and unemployed people.

Environmental and planning policies

The Law on Regional Development (2002) and The Law on Spatial Planning (2002) provide a framework for territorial planning and include provisions concerning local government responsibilities in environmental protection and the use of natural resources. Cabinet of Ministers Regulations on the *National Spatial Plan* and on *Local Government Territorial Plan* regulate all aspects of the spatial planning process. The Ministry of Regional Development and Local Government (formerly Ministry of Environment & Regional Development) prioritizes investments in water, wastewater, and waste management projects. These projects have been financed by EU Phare funding, grants, and soft loans from donor countries, international finance institutions, money from the national budget and the Natural Resources Tax through the National Environmental Protection Fund, and the Environmental Investment Fund. The largest environmental investments have gone to the national level cities and larger towns. Funding from the EU LIFE programme has also been used to fund projects in the nature and environment sectors. National transportation priorities are established in the *Transportation Strategy*. Road and bridge projects linked to national and trans-national roadways (VIA Baltica) are priority items. EU pre-structural ISPA funds are used for transport and environmental sector projects in urban areas, including Riga.[12]

Supra-national policies and programmes

In April 2003, Latvia signed the Treaty of Accession to the EU; a referendum in favour of joining the EU followed in September 2003. One of the preconditions for Latvia's successful integration in the EU was the ability to harmonize Latvian legislation with EU requirements. The process was initiated at the conclusion of the Treaty of Europe and has continued in parallel with the process of the accession negotiations. In its *2003 Supervision and Monitoring Report* the European Commission has stated that Latvia has met all requirements.[13]

Correspondingly, the Government has coordinated its 2003 *Single Programming Document* (SPD) with the European Commission and it will be used as the basis for allocation of the EU Structural funds in 2004-2006. In addition, the Framework Document for the use of the Cohesion Fund in 2004-2006 has been drawn up. While none of the priorities of SPD have an explicit urban focus, activities and projects are expected to benefit Latvian cities in at least three strategic areas: (1) the promotion of sustainable development; (2) the fostering of business activity and innovations; (3) the encouragement of the development of human resources and employment. Funding to Latvia from the structural funds in 2004-2006 will total 845 million euro (626 million euro from EU structural funds and 220 million euro from the Government budget).

On the other hand, EU accession requirements impose great demands on local governments. It is estimated that local authorities will need to invest approximately 180-200 million Lats to meet the

EU's landfill directive by 2015.[14] To meet EU directives on drinking water and urban wastewater, local authorities will need to invest approximately 571 million Lats, a sum which exceeds the fiscal capacity of both central and local governments (Ministry of Foreign Affairs, 2001). Critics also argue that small local authorities have insufficient capital budgets to meet the minimum investment size criteria demanded by the EU. The minimum size of EU-financed ISPA projects, for example, is 5 million euro (2.8 million Lats) with a minimum 25 percent municipal contribution. Most local government authorities with populations below two thousand will find it impossible to qualify (World Bank, 2003).

NOTES

1 Data source_ CSB, 2004

2 Ministry of Finance of the Republic of Latvia

3 Dematerialised security granted by the State, which can be used once as a method of payment for privatised State or Municipal property .

4 Ministry of Economics of Republic of Latvia

5 Ministry of Economics of Republic of Latvia

6 Ministry of Economics of Republic of Latvia

7 Monitoring Housing Policy and Housing Market Performance, Sasha Tsenkova

8 Data source: CSB, 2004

9 Ministry of Economics of the Republic of Latvia

10 Ministry of Economics of the Republic of Latvia

11 To ensure the development of knowledge-based sectors and the growth of products with a high added value, the Government emphasizes the need to promote cooperation between industry and research. In April 2003 the Cabinet Ministers adopted *The National Innovation Programme for 2003-2006*.

12 ISPA, the Instrument for Structural Policies for Pre-accession, is one of the European Union's three financial assistance programs to assist the candidate countries in Central and Eastern Europe in the accession process.

13 The full text of the report is available on the European Commission homepage http://europa.eu.int/comm/enlargement/report_2003/index.htm.

14 Ministry of Foreign Affairs, *Addendum to the Position Paper of the Republic of Latvia Chapter 22: "Environment" CONF-LV-60/00*, 2001, p. 29.

CHAPTER 7. HOUSING FINANCE IN ESTONIA

by
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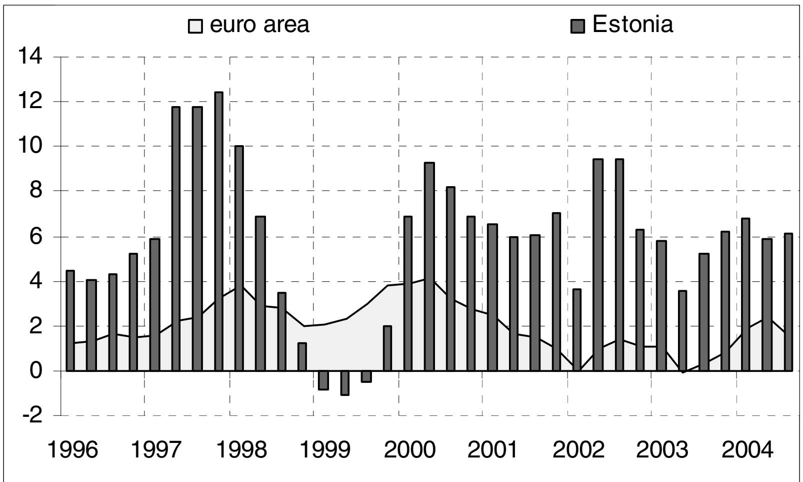
Tarmo Klettenberg[2]
Lembit Olev[3]

1. Macroeconomic Developments

Estonia has enjoyed five consecutive years of economic growth. Supported by improving demand for Estonian export and continuously strong domestic demand the **real GDP growth** accelerated from 5.2% in 2003 to an estimated 6% in 2004. Thus the respective euro area indicator was outpaced by more than 4 percentage points on an average (see Figure 1). Pursuant to the forecast of Bank of Estonia, the outlook remains positive also for next years - the economic growth is going to be close to the potential both in 2005 and 2006 (5-6%).

Figure 1. Real growth of GDP by quarters (%)



Sources: Statistical Office of Estonia; Eurostat

Estonian **export** of goods accelerated rapidly in the first half of 2004 and the export growth rate stabilized on a level, which positively contributed to the growth of Estonian economy. In 2004 the export development also became more balanced by components and various markets. Whereas in previous year the main factors of export growth were new and non-traditional branches (chemistry, metal), the year 2004 displayed considerable improvement in the field of traditional branches (wood processing, dairy products).

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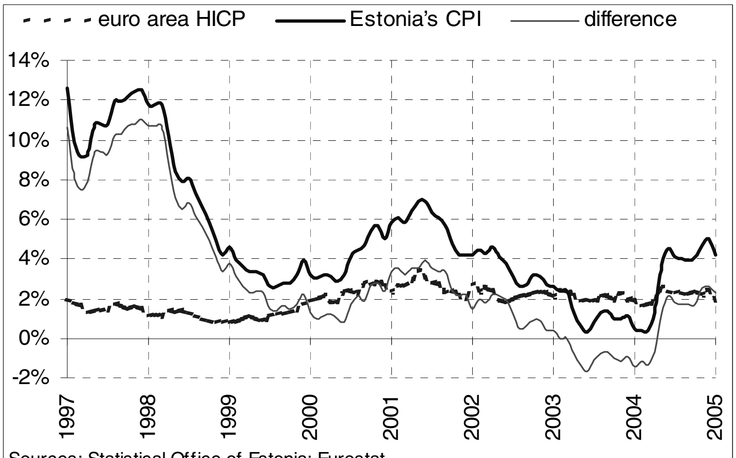
Although the share of export income increased in 2004, it was insufficient for balancing the economy. According to estimates, the **current account deficit** accounted to 12-13% of GDP. In large part, such worsening should be temporary and reflects the acquisition of the stock of goods (raw materials, consumer goods and durable goods) prior to the EU accession.

Although the **growth of domestic demand** somewhat decelerated, it still remained strong in 2004. The growth of private consumption was practically as high as in 2003, while growth of government expenditure even decelerated. Strong domestic demand was supported by investments, which made up more than 30% of nominal GDP in 2004. Strong growth of investments was mainly driven by new business projects, where residential construction played a major role.

The annual **consumer price increase** of 0.4% in the first quarter of 2004 was the lowest of all times. In the second quarter of 2004 the annual growth of consumer prices accelerated up to 3.2% (see Figure 2). This was mainly due to the one-time price increase, which accompanied the accession to the EU and was caused by the application of customs tariffs and co-ordination of fuel excise duties. In addition, the rapid inflation was sustained by the rise in oil prices on the world market. As a result of the factors mentioned the average CPI growth in 2004 was 3.0% exceeding euro area HICP by 0.8 percentage points. In autumn 2004 Bank of Estonia forecasted the annual consumer price growth for 2005 to be 3.4 per cent.

Figure 2. Annual growth of consumer prices in Estonia and the euro area



Sources: Statistical Office of Estonia; Eurostat

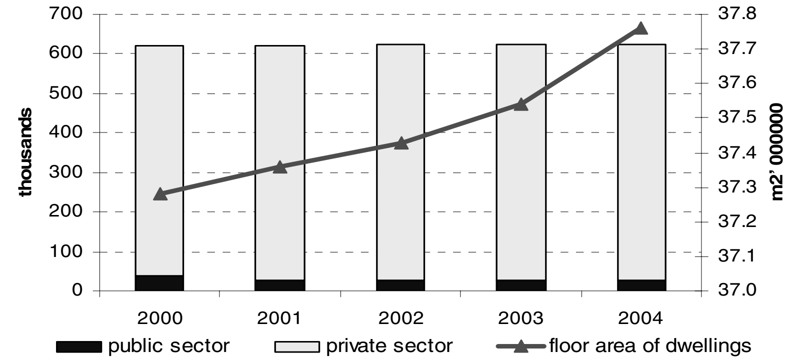
2. Housing Market Developments

Housing stock

The total number of dwellings in Estonia is ca 626,000 with the total floor area of ca 38 millions sqm (see Figure 3). **Per capita living area** in Estonia is 26 sqm, still half the EU average. About ¾ of all residential units are situated in apartment houses and only ¼ are single family houses. About 36% of apartments are 2-room apartments.

Privatisation in mid-1990s put **95% of the housing stock in private hands**. Dwellings were acquired in exchange for privatisation vouchers, which were allotted on the basis of years of employment. Much of the real property transferred to private ownership was often out of alignment with the actual needs and preferences of households. Nevertheless, the privatisation has been an important factor influencing housing demand and supply as well as forming good collateral base for mortgage finance.

Figure 3. Number of dwellings (left scale) and floor area of dwellings (right scale), 1 January

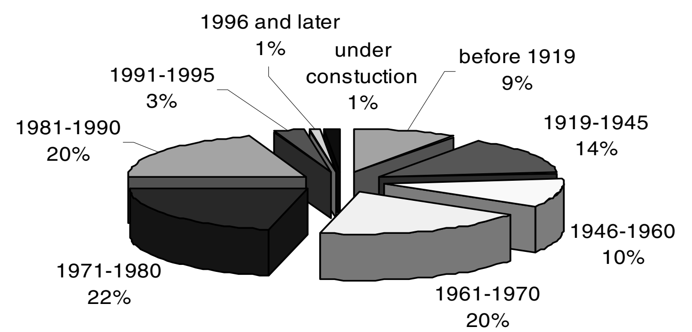


Source: Statistical Office of Estonia
Data based on the results of the 2000 Population and Housing Census.
Calculations contain data of the Construction Works Register.

Preferences of households regarding their living places have not changed remarkably. Due to the low income level the demand on flats in suburbs in Tallinn will remain the highest. One reason behind this is growing concentration of population in Tallinn – area. However, because prices in suburbs have been risen relatively fast, new apartments have been become more attractive. Most of these apartments are sold before they are completed.

The existing housing stock in Estonia is relatively old. The housing stock constructed before 1970 accounts for 54% of the total (see Figure 4), while the respective share for new dwellings (construction year starts from 1996) and dwellings under construction is about 2% of total. The stock of low-quality Soviet-era apartment blocks, built during 1971-1989, represents 44% of the present housing stock. Real needs for housing construction and/or major renovation have been increasing over the time. Currently the construction of new dwellings does not compensate for the amortisation of dwelling stock. Due to the fact that the supply of real estate is not flexible and can increase only gradually in the short run, the property prices in suburbs tend to rise over the business cycle.

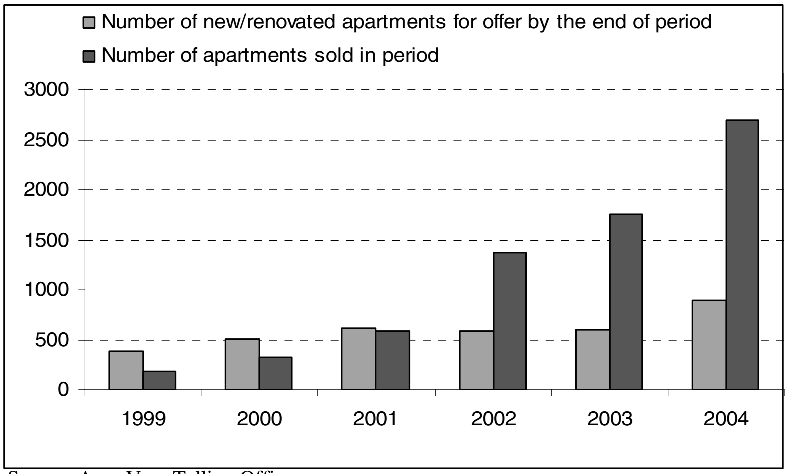
Figure 4. Structure of dwellings by period of construction, 1 January 2004



Data based on the results of the 2000 Population and Housing Census and the Construction Works Register
Source: Statistical Office of Estonia

The market of newly-built and renovated apartments in Tallinn, which has been developing at the fastest pace of the last five years, also continued the trend in 2004. Based on market overview of an Estonian property company (Arco Vara) approx. 2700 new apartments were sold in 2004 (including reservations). The sales volume is comparable with the summarized sales result of the last two years (see Figure 5). In 2004 the trend that developers move from city centre toward city outskirts continued targeting large middle class who today live in Soviet-era block buildings.

Figure 5. Number of sold/unsold apartments in new apartment houses in Tallinn.



Source: Arco Vara Tallinn Office

According to the former coalition agreement (2002) some municipal houses have been built and reconstructed in Tallinn in recent years. This was mainly triggered by the emerged situation accompanied by the privatisation processes. Namely, according to non-official estimation there are ca 22 thousand households staying in returned floor-space (5226 houses) today. Tenants living in returned houses have enjoyed different facilities and preferences for resettlement and improving their living conditions, included special soft loans total 507 million kroons. Since 2001 more than 100 million kroons have been assigned to local governments for loans, loan securities and non-repayable financing of public housing construction.

Prices and rents

Supported by favourable loan conditions and optimistic expectations over future incomes the demand on housing in 2004 was stronger than ever before; as a result the growth of **housing prices** in all major cities started to accelerate. In the first half of 2004 the high growth rates (both in volumes and prices) were to some extent also induced by expectations related to the EU membership. As some months after the EU accession neither the demand on housing did not weaken nor housing prices stabilise one could conclude that improving consumer confidence accompanied by attractive borrowing conditions have been the main driving forces in recent housing market developments. However, as the oncoming of new credit-eligible customers is limited and the supply of new housing is picking up the growth of prices in secondary market is limited.

In 2004, prices of dwellings in older buildings in Tallinn increased in average by 15-20% and prices of dwellings in new buildings respectively by 10-15%. Pursuant to the estimates of major Estonian real estate companies, the housing market is expected to settle down in 2005 with average prices climbing up by 5-10% depending on the type and the location of a real estate.

Price differences between major cities of Estonia are still remarkable (see table 1 and Figure 6). Prices of new flats in the city centre of Tallinn start from 1,000 EUR, while the top prices reach 1,950 EUR per sqm. Secondary market prices range between 700-1,100 EUR per sqm in the city centre, while in the suburbs between 500-700 EUR per sqm. Old Town renovated apartments sell for 1,700-2,300 EUR per sqm.

Table 1. Average prices of apartments in February 2004, EUR per square metre

	4-rooms	3-rooms	2-rooms	1-rooms
Tallinn city centre - un-renovated	720	760	810	820
Tallinn city centre - renovated	930	930	950	970
Tallinn city centre - new appartments	960	1000	1010	1060
Tallinn suburb (satisfactory conditions)	610	650	690	670
Tartu	500	490	520	560
Pärnu	430	470	490	510

Source: Äripäev

Estonia also has yet to develop a **rental market** with flexibility and adequate supply. Renting generally remains an inferior alternative to home-buying; Estonians prefer to buy their own apartments, not rent them. Increased labour mobility and widening regional differences further militate for an efficient housing market. In Tallinn the rents are partly determined by migration (incl foreign workers), while in Tartu by students. As supply of flats increases, rents should remain stable or even drop over the medium term (see Figure 7).

Due to favourable borrowing conditions, monthly rents do not differ much from monthly loan repayment (incl interests), giving also preference for home buy against renting.

Figure 6. Average prices of 2-rooms dwellings of satisfactory conditions (dwellings, which need maintenance repair (painting, paper-hanging, changing of flooring, etc.)

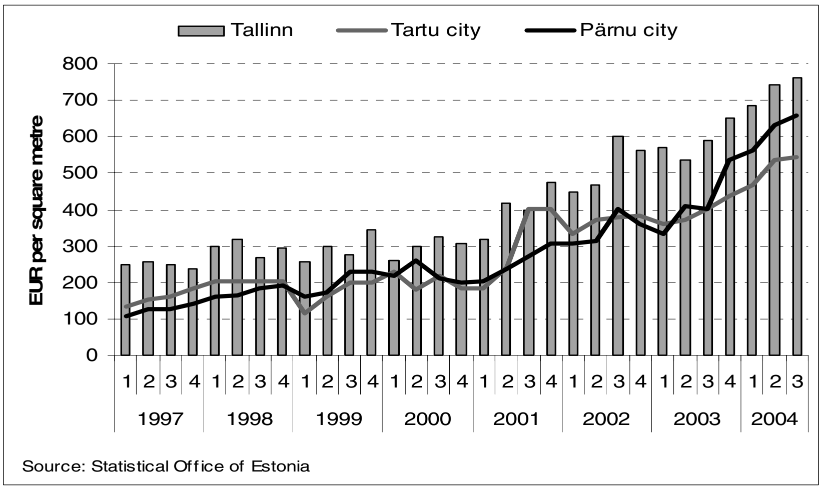
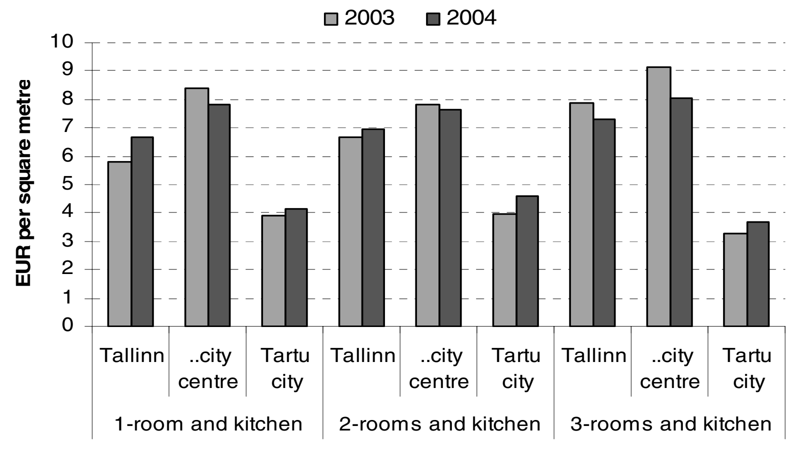


Figure 7. Average monthly rent per square metre of residential area.



Rent excluding public services
Source: Statisticl Office of Estonia

Taxes and fees

As regards taxes and fees the following aspects are most important in Estonian regulatory framework:

- Private owners must declare rent collected as income, and pay the flat 26% personal income tax at the end of the year. The only sensible way to rent property in Estonia is through a company structure as it allows deduct all expenses related to the property. The enterprises in Estonia are not subjects for the income tax until profits are distributed.

- Loan interests paid for housing loans are tax deductible ex post.

- Profit from the sale of second homes is taxed similarly to that of the income (26%). Companies, of course, must declare any capital gain as income.

- While purchasing the real estate a notary fee of 0.1% of the transaction value as well as a registration fee (to register the property in the real estate registry) of 0.075% of transaction value is applied.

- Estonia has a property tax only on land, which range from 1 to 2% (depending on the municipality) of the cadastral value of the land.

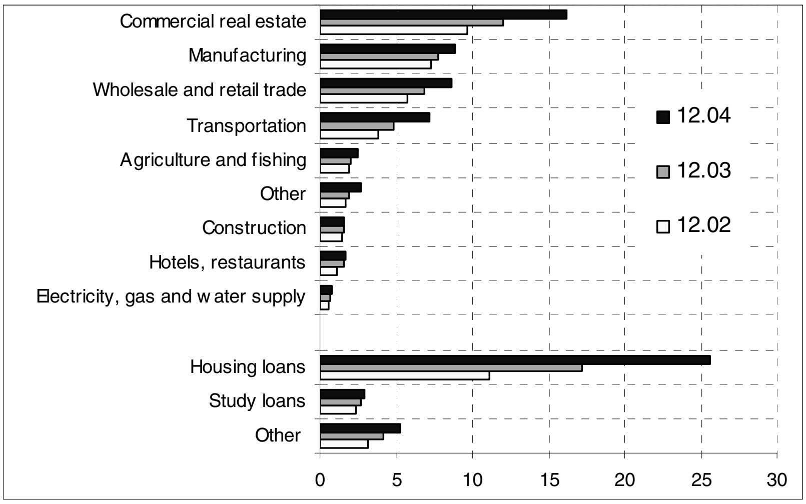
- Since May 1, 2004 all the companies which are engaged in development of land and apartments must charge VAT on the sales price, not just on the construction costs. This increased the cost of new properties by 3-4%.

3. Housing Finance Market and System

Housing loans

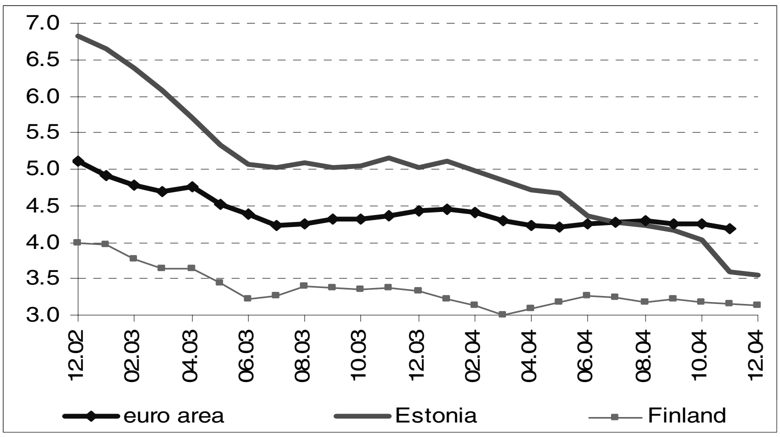
Since 2001, the largest part of the real sector loan and leasing growth has been channelled to the real estate loans and leasing (commercial and housing loans). This situation has been enhanced by aggressive competitive activity in the banking market, which has specially pushed the supply of housing loans (see Figure 8).

Figure 8. Commercial banks' loan and leasing portfolio, in billons of kroons



Like previous years, the year 2004 started with an "interest war." Low euro money market interest rates[1] together with toughened competition in domestic retail market have considerably lowered the **interest rates on housing loans** (see Figure 9). At the end of 2004 the average interest rates were almost twice lower than two years ago. After a seasonal break in the first months of 2005, banks activated new sales campaigns in March. However, as the retail interest margin in Estonia is already very low the interest rates are not expected to fall further substantially in medium term.

Figure 9. Interest rates on new housing loans in Estonia and euro area (incl. Finland; %).



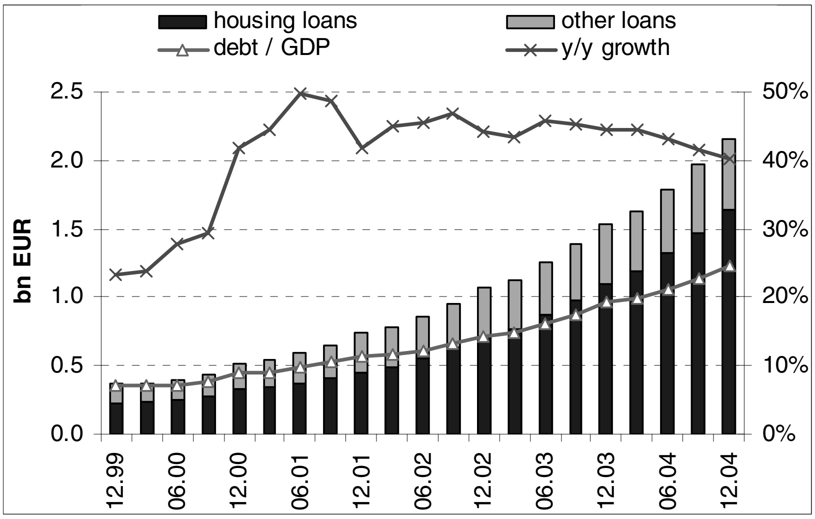
Source: national central banks; ECB

The **annual growth of housing loans** has been over 50% already for last two years. In the second half of 2004 the growth rate declined somewhat due to the very high base accumulated in previous years.

Stabilising growth rates did not reflect any weakening of the loan demand. The main market participants expect strong demand on housing loans to continue for the next 2-3 years.

Fast loan growth has led to a surging **debt level**: at the end of 2004 the household debt amounted to 25% relative to GDP and 45% of the disposable income, as a preliminary estimate. Compared to the EU average, there is still a lot of room for growth even though Estonia has moved briskly closer to the countries with lower debt levels. Among the Central and Eastern European countries the debt burden of Estonia's households is the highest, arising mainly from the significantly larger volume of housing loans.

Figure 10. Households' indebtedness



A survey by the market research company TNS Emor found that about 13% of households had taken loans for acquisition of real property in Estonia. Due to the overall low income level in Estonia the number of new-comers can not increase rapidly in next periods[2]. As one cannot predict a steep rise in the loan volumes on the basis of a presumed income growth of the lower-income group families, Bank of Estonia expects stabilising loan demand in medium term[3].

Lending standards have been developed since 2001, but general risk assessment concerning households is still based on income and collateral. The age of borrower plays a role when the term of housing loan is considered (as a new loan product, housing loan with a maximum 40-year term is offered for young families).

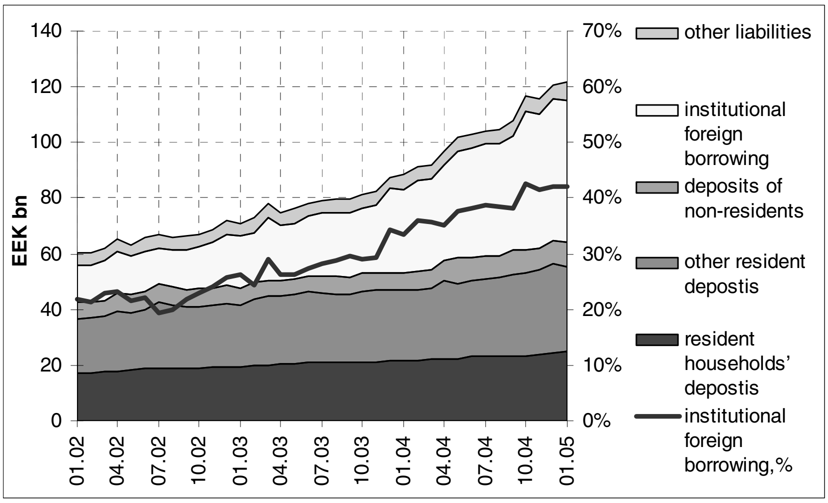
The main differentiation of customers is provided by income. The borrower's minimum net monthly income has to reach a certain level to get any loan from the bank. The required minimum net monthly income level for borrowing is about average net salary level in Estonia. In low-salary categories up to 30% of borrower's monthly average net income may be spent on monthly loan/leasing payments and interests. In high-salary categories the upper limit for monthly loan repayment is set by 40-50% of the net income.

The main collateral of housing loan must be the property purchased, constructed or renovated. Additional guarantee can be another dwelling object, a deposit or the KredEx guarantee. The loan-to–value (LTV) ratio of housing loans is generally around 75%. However, in case of new or renovated dwelling in good area and liquid secondary market, the LTV ratio can be up to 90%.

Funding of mortgage loans

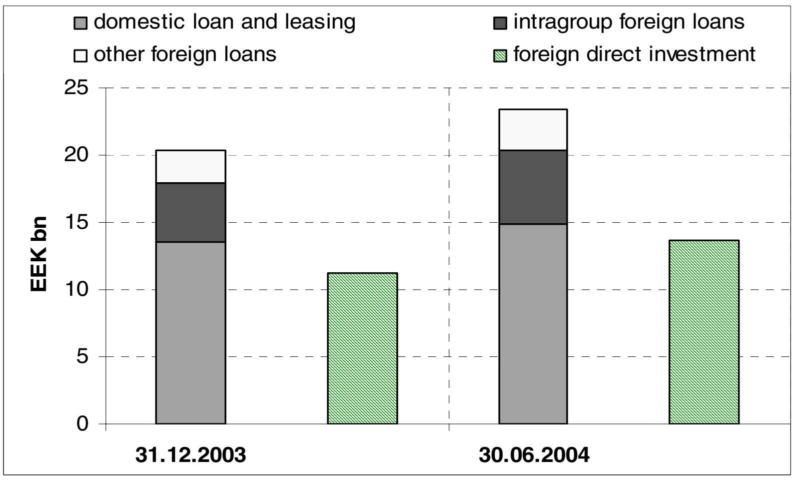
Depositing by households and enterprises with domestic banks has displayed modest growth in recent years; in 2004 the annual growth of deposits of households and non-financial enterprises accelerated somewhat, and accounted for 16% and 23% respectively. Considering strong demand on loans the domestic savings still remained inadequate. As a result, banks have used more external funds (see Figure 11) that increased more than 69% over the year 2004, accounting for 42% of banks' total liabilities by end-year. Nearly a half of the growth in foreign borrowing accounted for the parent banks. Affected by the favourable impact of raised ratings on the price of financing also the inflow of more market-based resources was remarkable. However, the differences in funding dynamics mainly reflect different funding pattern of foreign banks' subsidiaries.

Figure 11. Banks' liabilities and share of foreign borrowing



While in housing loans' segment domestic banks are the dominant players, they have to "compete" with foreign investors when financing commercial real estate activities. About 1/3 of debt to the real estate and construction enterprises comes from abroad, mainly from parent companies (see Figure 12).

Figure 12. Structure of financing real estate and construction enterprises



4. Regulation

Law of Property Act (1993)

Land Register Act (1993)

Land Cadastre Act (1994)

Credit Institutions Act (1999)

Law of Obligations Act (2002)

Support of Enterprise and State Loan Guarantees Act (2003)

Bankruptcy Act (2004)

Translations of aforementioned acts are available on the Web site of the Estonian Legal Language Centre: http://www.legaltext.ee

Land and title registration

The Centre of Registers is a state agency working under the Ministry of Justice.

The digital information of register parts and a land registry journal in the land registry of courts on a registered immovable is saved and stored in the Centre of Registers. The Centre of Registers guarantees the electronic saving, storing and reproducing of land register information. The information stored on paper at courts has legal effect at present. The digital database of the land register is not complete (some information is on paper) and does not correspond exactly to information on paper.

The Centre of Registers offers an information service and online-service based on the database of the land register of the registration departments of courts.

The Land Register ensures legal certainty and reduces the risks related to the immovable property transactions, because:

Real rights relating to an immovable property are made visible through the Land Register;

Real rights in immovable property are created by an entry in the Land Register and extinguish by deletion of the entry from the Land Register;

Entries in the Land Register are made in the order of arrival of applications.

The Land Register is maintained by land registry departments of local law courts. The registration applications are reviewed in written judicial proceeding. Maintaining the Land Register by the judiciary ensures legal competency and independent decisions.

As a rule, the immovable property transactions are notarial. Notary verifies the data needed and represents the parties to the transactions in the land registry department (among the rest submitting and redeeming documents).

Issue for capital adequacy framework

The treatment of mortgage loans in respect of credit risk in banks' capital adequacy framework is different from the other loans one. In calculating the capital adequacy, the mortgage loans belong to 50% weight risk category while other loans to individuals are dealt within 100%- weight risk category. However, the claim is considered a fully mortgage backed in case the amount of it does not exceed 2/3 of the value of the mortgage.

5. Housing Policy

Tax advantages

According to the Income Tax Act a resident natural person has the right to deduct, from the income which he or she receives during the period of taxation, interest payments made during a period of taxation to a credit institution that is a resident of the European Union or financial institution which is subsidiary of that company or a branch of a non-resident credit institution entered in the Estonian commercial register for a loan or finance lease taken in order to acquire a house or apartment for himself or herself or for his or her spouse, parents or children. Interest payments for a loan or lease taken in order to acquire a plot of land in order to build a house may be deducted from income under the same conditions.

The State loans and guarantees system

The Support of Enterprise and State Loan Guarantees Act (Act) sets out the bases, principles and organisation of the state support of enterprise and the grant of state guarantees for loan agreements and leasing contracts. According to the Act housing loan means a loan granted to persons which belong to a target group determined by the government or granted to apartment associations or housing associations in order to acquire housing or improve living conditions, including a loan granted in order to improve the economy, safety and maintenance of the residential building managed by the association, or a leasing contract entered into for the same purpose. State guarantee means the state-guaranteed obligation of the guarantor, which arises from the guarantee contract entered into in the cases and pursuant to the procedure prescribed in the Act, to pay the debt of the debtor arising from a financing transaction to the guarantee holder.

State guarantees are granted by a foundation established in order to grant state guarantees for business loans and housing loans (The Estonian Credit and Export Guarantee Fund KredEx.). A credit institution which holds a valid activity licence may be the recipient of a state guarantee. If a guarantee is granted for an obligation arising from a leasing contract, a financial institution which belongs to the consolidation group of a credit institution, is subject to supervision by the Financial Supervision Authority and holds a valid activity licence may be the guarantee holder. In such case, all the provisions concerning credit institutions in the Act also apply to financial institutions.

KredEx is a self-sustaining fund in the jurisdiction of the Ministry of Economic Affairs and Communications, whose goal is to support the development of enterprises, exports and housing. KredEx, which was founded in July 2000, provides various guarantees, which serve to improve the availability of capital for the SME-s, help to manage the export risks of enterprises and support the financing of home purchases and renovations by banks. KredEx acts on the principles of insurance and pursues the goal of creating a well-balanced and self-sustaining diversified portfolio.

Based on *The Support of Enterprise and State Loan Guarantees Act* KredEx may grant a guarantee for a housing loan pursuant to the procedure prescribed in the Act if the recipient of the loan is a person belonging to the target group determined by the government, or an apartment association or housing association. The liability of a foundation arising from a guarantee contract only extends to the principal obligations of the debtor and supplements the liability of the debtor. Upon performance of an obligation of a debtor, a claim of the creditor shall be transferred to the foundation to the extent the obligation is performed. The provisions of the Law of Obligations Act concerning contracts of suretyship apply to guarantee contracts, taking account of the specifications provided for in the Act. No state guarantee granted by KredEx shall at any time exceed 75% of the balance of the loan commitment of the recipient of the loan. A state guarantee granted in an amount which exceeds 75% shall be valid only to the extent of 75%. The total amount of valid guarantee contracts entered into by the KredEx pursuant to the Act shall not at any time exceed 950 million kroons in the case of housing loans.

In 2001, two new products were launched to complement the existing guarantee for young families – the loan guarantee for young specialists and for apartment associations. The guarantee for young families is designed for couples or single parents who raise a child of 16 years or less and who wish to purchase a new home or renovate the existing one. People who are up to 30 years old, with a higher or vocational secondary education and who have a valid employment contract can apply for the young specialists 'loan guarantee. In both cases, the guarantee helps to lower the applicant's self-financing rate to 10% instead of the usual 34%.

As the growth rate of loans backed by KredEx's guarantee has been slower than the overall growth in the Estonian housing loans market, KredEx's share in the turnover of all new loans is falling. In 2003 the estimated share of KredEx backed housing loans was 18.5%. The trend will continue as some of banks have showed their interest to provide mortgage insurance under same conditions.

The draft of Mortgage Bond Act

The Ministry of Finance prepared the first draft of a Mortgage Banking Act (German model) in the beginning of the nineties. In 1999 the Minister of Finance formed a working group to work out a contemporary mortgage credit model (secondary market mechanism) for Estonia and to set up a legal basis for that. This working group was divided into two subgroups: 1) mortgage banking model group; 2) special purpose investment fund model group. After its second reading in the Parliament the draft of Securities Market Act contained a new part on mortgage bonds (the adapted German model) but finally the act was adopted without the Part on Mortgage Bonds.

In 2002 the Minister of Finance formed a new working group with a goal to draft the Mortgage Finance Act (the name of the act is conventional). The result is the draft of the Mortgage Bond Act (MBA). The purpose of the MBA is to establish a legal framework for the issuance of mortgage bonds and at the same time to fulfil the criteria of the UCITS directive article 22 (4). At the same time it would be the elimination of competitive disadvantage (stronger competition in Europe and the EU-enlargement will increase the need to access the cheapest, triple A rated funding). MBA is mainly based on the German model but has four very important differences: 1) authorised issuer is besides the special mortgage bank also universal bank; 2) there is no special supervisor (trustee); 3) if a bankruptcy proceeding has been instituted the payment is due for all mortgage bonds (no continuity of the cover asset pool until the last mortgage bond has been redeemed); 4) issuing of public sector bonds not regulated.

During the period of 2003-2004 the text of MBA was improved. At the same time the main principles of the draft has remained the same. Due to the unfavourable situation for the processing of the draft of MBA it is not decided when it will be submitted to the government.

NOTES

1 Mortgage lending is overwhelmingly done with floating rates, whereas mostly related to Euribor.

2 The launch of second pillar of pension reform gave an incentive for employees to declare their earnings as an official wage. That one-time effect increased the number of people eligible for bank credit.

3 Financial Stability Review. Bank of Estonia. November 2004

CHAPTER 8. HOUSING FINANCE IN SLOVENIA

by

Barbara Staric-Strajnar*

1. Macroeconomic Characteristics

Gross domestic product

The revision of national accounts resulted in a minor change of the GDP estimate for 2002 and a first release of the 2003 figure. After the last SORS' release of the revised annual national accounts estimate since 2000 (in September 2004), the estimate of economic growth for 2002 was 0.1 p.p. below the earlier estimate (3.3% instead of 3.4%), while estimates for 2000 and 2001 remained unchanged (3.9% and 2.7%, respectively). The first annual economic growth estimate for 2003 was 2.5%, which is 0.2 p.p. above estimates based on quarterly figures and at the same time the lowest figure after 1992. The cooling of economic growth in Slovenia in 2003 was induced by the modest growth of foreign demand, even more so than in the two previous years when economic growth was also below the average of the previous medium-term period (4.4% in the 1996-2000 period). Despite this substantial slowdown, GDP growth in 2003 was nevertheless more than 1.5 p.p. above the averages of the EU-15 (0.8%) and EU-25 (0.9%).

The economic situation in 2003 was strongly affected by the unfavourable trends in the international economic environment. There was also a shift in the GDP growth structure. The modest real exports growth in 2003 (3.2%, compared with 6.7% in 2002) was mainly due to the weak economic growth in Slovenia's main trading partners in the EU[1]. Unlike 2002, 2003 also saw a drop in the levels of exports to the countries of former Yugoslavia, except Croatia. Exports to Russia and the CEFTA countries sustained the relatively strong growth from the previous year. On the other hand, domestic demand gained momentum in 2003 after a three-year period of modest growth, which led to changes in the GDP growth structure. Total domestic demand rose by 4.7% in real terms and became the main driving force behind the growth. For the first time after 1999, domestic consumption growth (2.7%) exceeded GDP growth (0.3% in 2002). It was largely spurred on by the beginning of the new purchasing cycle enabled by the disburdening of income from old loans and new borrowing opportunities under significantly improved terms. Gross investment growth also picked up to total 10.5%. Within this growth, gross fixed capital formation rose by 6.3% (mainly as a result of investment in motorway construction). The contribution of inventories to economic growth was also substantial (1.1 p.p.). The high growth of domestic demand influenced stronger imports growth, which, coupled with the laggard exports growth, resulted in a high negative contribution of the foreign trade balance to economic growth (-2.2 p.p.).

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Economic growth in 2004 was the highest in the last five years and totalled 4.6%. This strengthening was largely produced by accelerated exports compared to the year before (12.6% real growth over 3.2% in 2003), which also exceeded the autumn forecast expectations, while the real growth of domestic consumption sustained the sound 2003 level and was in line with the autumn forecast (4.7%). The increase in imports was also strong (12.4% over 6.8% in 2003), hence the contribution of external trade was still negative (-0.2 p.p.) yet considerably less so than in 2003 (-2.2 p.p.) and less than anticipated in autumn. According to the SORS' estimate, the higher number of working days in 2004 contributed 0.5 p.p. to last year's GDP growth.

Export growth was mainly driven by accelerated exports to the old EU member countries (where growth was modest in 2003), notably Italy, France and Austria and other less traditional trading partners (Belgium, Spain, Ireland, Portugal), while exports to Germany rose less rapidly and slowed down further towards the end of the year. Exports to Croatia, Serbia and Montenegro and Russia picked up as well. A substantial increase was also recorded in imports from the EU; on the other hand, imports from Russia, the USA and especially other countries declined. Imports from the countries of former Yugoslavia in which the regime remained unchanged continued to increase. According to preliminary data, January continued to enjoy robust growth of external trade volume. Domestic consumption registered stronger growth of private consumption last year (3.5% over 2.7% in 2003) which was in line with forecasts. With the modest rises in wages and employment, it was generated by the relatively strong growth of other remuneration which increased the disposable income and the boosted household borrowing (mainly long-term) in banks, which in turn stimulated the consumption of durable and semi-durable goods. Increased borrowing was driven by nominal interest rate cuts linked to entry to the exchange rate mechanism ERM II, and also, in our estimate, by the disburdening of household income from the repayment of loans taken out in 1999, whereby the population's credit credit worthiness rose again. The real rise in gross fixed capital formation was at a slightly higher level than the year before (6.8% over 6.3%) and in line with expectations. According to our estimates, this was, to a large extent, based on investment in machinery and equipment; in addition, figures on issued building permits indicate stronger growth of housing investment, while investment in civil engineering sustained the high level of 2003. Inventories rose more than expected, contributing 0.8 p.p. to last year's annual economic growth after the high values recorded in 2002 and 2003. The real growth of government consumption was lower than the year before (1.7% over 2.6%) and lower than forecast in autumn.

In line with the autumn forecast, a 4.5% increase in value added was achieved in 2004 as a whole (5.0% in basic industries and 4.2% in services). Compared with 2003, the growth in agriculture accelerated strongly after the normal crop recorded in the droughty 2003. In last year's normal hydrological conditions, the increase in value added also strengthened in electricity, gas and water supply. After the slowdown seen in 2003, the growth of value added in manufacturing rebounded last year on the back of favourable economic trends and high exports growth (5.4% over 3.9% in 2003). In construction, following the impetus seen in 2003, growth slowed down again: housing construction picked up while civil engineering remained at the same level as in the previous year. Services recorded a higher increase in value added compared to 2003 in wholesale and retail trade, financial intermediation, health and social work and other social and personal services, while growth was slower in hotels and restaurants and in public administration.

Table 1: Contribution of expenditure components to gross domestic product (GDP) growth in Slovenia in 1996-2003

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Real GDP growth, in %	3.6	4.8	3.6	5.6	3.9	2.7	3.3	2.5	4.6
Contribution of individual components to GDP growth, in p.p.									
Foreign trade balance	0.2	-0.3	-1.8	-3.9	2.4	1.7	1	-2.2	-0.2
Private consumption	1.6	1.5	1.7	3.4	0.2	1.3	0.2	1.5	1.9
Government consumption	0.6	0.4	1.1	0.6	0.5	0.8	0.3	0.5	0.3
Gross fixed capital formation	2.3	3.0	2.4	5.4	0.2	1.0	0.8	1.6	1.8
Changes in inventories and valuables	-1.1	0.2	0.2	0.1	0.6	-2.1	1.0	1.1	0.8

Source: SORS.

Unemployment rate

In 2004, registered unemployment continued to fall; survey unemployment also declined after the halt seen in 2003. The number of people registered as unemployed hovered around 125,000 in 1993-1998 and the registered unemployment rate was between 14% and 14.5%. Up until 2001, the number of the registered unemployed fell to an average of 102,000 and the registered unemployment rate to 11.6%. In 2002, both the number and rate of registered unemployment stayed at the level of the previous year, while they again dropped slightly in 2003 and 2004. The average number of people registered as unemployed was 92,826 in 2004 (90,728 in December), while the average rate of registered unemployment totalled 10.6%. The number of unemployed people according to the labour force survey hovered at around 70,000 in 1995-2000, while the survey unemployment rate ranged between 7% and 8%. The number of the unemployed dropped to 62,000 by 2002, then rose to 64,000 in 2003 and remained at that level (on average) in 2004. The survey unemployment rate, which had already dropped to 6.4% in 2001 and 2002, rose to 6.7% in 2003, then fell to 6.3% in 2004. Slovenia's unemployment measured by the international methodology has been below the EU average ever since it started to be measured and hovered around the average of the OECD countries.

Registered unemployment flows in 2004 show a comparatively more favourable picture than in previous years. For the first time in four years, the number of unemployed people who found a job in 2004 was higher than the year before. 54,257 unemployed people were hired (7.4% more than in 2003). The figure includes the substantial rise in jobs subsidised through the active employment policy measures (up 30.1%). Within these jobs, the number of participants in the public works scheme increased after several years of decline (up 28.9%). Other subsidies recorded a 33.5% rise last year. Non-subsidised jobs that accounted for 86.7% of the total hiring of unemployed people in 2004 were up 4.6% compared with 2003. Up until November it seemed that the inflow into unemployment due to job loss, which had been rising since 1999, will be lower than the year before in 2004. December's inflow, however, was very high, so that a total of 69,577 employees lost their yobs in 2004 (1.1% more than in 2003). The annual inflow of first-time job-seekers was again slightly higher than in 2003 (up 2.2%), while the number of deletions for other reasons decreased by 1.6%. The deletions from unemployment registers for other reasons were mostly voluntary or due to failure to report at the employment service offices (17,600); in addition, over 4,000 deletions were due to retirement and over 7,000 due to a return to school. A further 2,268 persons were transferred to another register in 2004 in accordance with other laws[2], which was 70% less than in 2003. The overall number of people registered as unemployed thus dropped by 5.5% until the end of 2004 compared with December 2003.

The structure of registered unemployment is changing: the shares of older, long-term and unskilled unemployed people are declining, while the shares of unemployed first-time job-seekers and women are on the increase. This was partly due to high deletions from unemployment registers for various job-unrelated reasons, in addition to targeted active employment policy measures, especially subsidies for new jobs and training programmes for the unemployed. The average share of women already exceeds 53% (52.8% in 2003), while the share of first-time job-seekers totalled 25% (23.2% in 2003). The share of young unemployed people remains almost unchanged (26.2%). On the other hand, the share of the unemployed aged over 40 dropped to below 43% (compared with 44.1% in 2003 and 51.7% in 2000, when it was the highest). The shares of jobless people also fell in the following groups: people aged over 50 (21.0% over 21.4% recorded in 2003 and 27.5% in 2000), long-term unemployed (46.2% over 48.6% in 2003 and 63.7% in 1999) and unskilled unemployed (41.6% over 44.2% in 2003 and around 47% in the 1995-2002 period). The average duration of unemployment shortened by over 2 months (to 22 months and 24 days) compared with 2003. Both the registered and survey female unemployment rates remained significantly higher than the respective male unemployment rates (see table). Youth unemployment (ages 15-24) remains relatively high, although it is getting lower.

The government continues pursuing the goals of the National Programme of the Labour Market Development and Employment by 2006 and the European Employment Strategy. Since 1999, the Slovenian government's employment policy has taken into consideration and applied the European Union's recommendations and guidelines in the field of employment. In September 2004, the government adopted its first National Action Plan for Employment[3], which is entirely on a par with the national plans of the EU member states in content and form and is adjusted to the European Employment Strategy and the Lisbon employment objectives. The key activities include raising the educational level or vocational qualifications of the labour force, reducing structural imbalances (cutting the shares of long-term unemployed people and the unemployed with no vocational training), participation of all young unemployed people who have not found work within 6 months and all other people out of work for 12 months or more, in active employment policy programmes, reducing regional imbalances in the labour market, control over obligation fulfilment of unemployed people, preventing shadow economy and illegal employment, and further development of social partnership.

Table 2: Unemployment rates in Slovenia, the EU and OECD in the 1995-2004 period, in %

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Survey unemployment rate										
Slovenia	7.4[1]	7.3	7.4	7.9	7.6	7.0	6.4	6.4	6.7	6.1[1]
men	7.7[1]	7.5	7.1	7.7	7.3	6.8	5.9	5.9	6.4	5.7[1]
women	7.0[1]	7.0	7.6	8.1	7.9	7.3	7.0	6.8	7.1	6.4[1]
young people (aged 15-24)	18.8	18.8	17.6	18.6	18.1	16.8	18.1	16.7	17.4	14.2[1]
EU-25	n/a	n/a	n/a	9.4	9.2	8.8	8.5	8.9	9.1	8.9[1]
EU-15	10.1	10.2	10.0	9.4	8.7	7.8	7.4	7.7	8.1	7.9[1]
OECD	7.7	7.7	7.4	7.1	6.8	6.3	6.5	6.9	7.1	
Registered unemployment rate										
Slovenia	13.9	13.9	14.4	14.5	13.6	12.2	11.6	11.6	11.2	10.6
men	14.1	13.7	13.6	13.4	12.4	11.1	10.4	10.4	9.7	9.1
women	13.7	14.0	15.3	15.7	15.0	13.5	12.9	13.1	13.0	12.4

Source: SORS, Eurostat, OECD. Note: 1 Q2.

Inflation

Having persisted at the 7%-10% level in 1995-2002, inflation fell to below 4% in 2004. The fluctuation of inflation at a relatively high level in the period after 1995 was mainly the result of economic policies that had not pursued price stability, i.e. irresponsiveness of prices to changed macroeconomic conditions, as their main goal. In part, the long-lasting high inflation levels were also fuelled by the unfinished structural reforms related to indexation, to the composition and level of general government expenditure and to the increase in efficiency (restructuring) in sectors where competition is still insufficient.

The sustainable lowering of inflation seen in the past two years has resulted from co-ordinated measures carried out by the Bank of Slovenia and the government of RS. When the BS and the government decided on entry to the exchange rate mechanism ERM II and early introduction of the euro, they adopted measures that have led to sustainable lowering of inflation. While in 2003 the main driving forces behind inflation cuts were measures taken through administered prices and fiscal policies, further lowering of inflation seen in 2004 was essentially hinged on the tolar exchange rate's stabilisation upon entry to the ERM II at the end of June 2004. Taking into account the almost complete pass-through of the exchange rate to price rises, the tolar's exchange rate stabilisation abolished a key inflation factor which had in previous years contributed around 50% to overall price rises. Nevertheless the year-on-year growth of the exchange rate totalled 1.3% due to its gradual depreciation seen in the first half of 2004. Simultaneously, the government continued to carry out the Administered Prices Rise Plan for 2004 and 2005 and co-ordinated adjustment of fiscal burdens. In contrast to 2003, the main objective of administered prices policy (to ensure consistent rises of administered and market-determined prices) was not achieved in 2004. However, the faster growth of administered (up 9% in 2004) than market-determined prices (up 2.1%) was mainly attributable to external factors. Higher prices of oil and hence of liquid fuels for transport and heating contributed 1.0 p.p. to inflation (71% of the overall administered prices increase). As oil price changes had a comparatively stronger impact on inflation in Slovenia than in other EU countries (due to the bigger share of fuels in the price index, the relatively low tax share in retail prices and the relatively high dependence of the economy on fuels), the government also continued the counter-cyclical adjustment of excise duties on liquid fuels for transport and heating, thereby cushioning the volatility of liquid fuels prices (when oil prices surged by about 70%, the adjustment of excises helped to reduce inflation by up to 0.4 p.p.). Higher excise duties on liquid fuels contributed 0.2 p.p. to end-year inflation; a further 0.2 p.p. came from further harmonisation of excises on tobacco products with the EU tax system.

Slovenia's entry to the EU contributed to further reduction of inflation. In addition to the tolar's exchange rate stabilisation following entry to the ERM II, EU accession also led to changes in trade regimes, especially the elimination of customs duties on food products. At the end of 2004, food prices were lower than the year before, which is why inflation was by 0.2 p.p. lower in 2004 than in 2003 when higher food prices added 0.8 p.p. to inflation.

In spite of its considerable lowering, inflation still deviates sharply from the Maastricht criterion. The Maastricht criterion, calculated on the basis of average (HICP[4]) inflation, totalled 2.2% in December 2004, while average (HICP) inflation in Slovenia came in at 3.7% at the end of 2004. Further sustained lowering of inflation that will enable the fulfilment of the Maastricht criterion in 2006 in accordance with the Programme for Entering the ERM II and Introducing the Euro will thus require not only strict further implementation of the adopted policies, but above all the reduction of factors creating upward pressure on inflation due to structural imbalances.

Table 3: Consumer price rises in Slovenia and the EU in 1995-2004

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Slovenia, year-on-year growth rates, in %										
Consumer prices	9.0	9.0	8.8	6.5	8.0	8.9	7.0	7.2	4.6	3.2
Goods	7.1	8.0	8.5	5.6	7.8	8.8	6.2	6.4	3.9	2.5
Services	15.9	12.2	9.8	9.3	8.8	9.2	9.6	9.4	6.5	4.9
Administered prices	10.0	8.4	16.9	11.1	10.4	16.0	10.5	9.2	4.0	9.0
Energy	8.2	5.6	20.9	13.2	11.0	18.9	6.7	5.5	3.5	10.3
Other	11.4	10.6	12.4	8.6	9.6	12.0	17.0	14.7	4.8	6.1
Core inflation	N/A	7.2	6.4	5.0	4.1	6.9	7.4	6.9	4.2	2.7
Euro area, year-on-year growth rates, in %										
Consumer prices	2.5	2.1	1.5	0.9	1.7	2.5	2.0	2.4	2.0	2.3

Source: SORS (consumer prices), IMAD's estimates (administered prices, core inflation), Eurostat (consumer prices in EU).

2. Supply and Demand of Housing

The gap between housing supply and demand is relatively big in Slovenia, given that, for example, a total of 14,674 housing units were built in 1981 and a mere 7.265 in 2003. After 1991, the housing construction has dropped, so that about 8000 apartments are now constructed yearly. In relation to this, we should mention that the construction of rental apartments has dropped the most. The main reason for this is a strong recession in construction industry caused by a reduced budgetary financing of housing. The result is rapidly increasing the prices of newly-constructed dwellings and of commercial rents. The demand for non-profit units is the greatest and it largely exceeds the supply. The data for the year 2004 confirm this.

3. Housing Finance Market and System

Housing loans

Housing lending is relatively well developed. With assets of approx. 3.9% of GDP in 2003, the housing loan market is of mid-size compared to other transition countries. It is smaller than Hungary's, but larger than the Czech Republic's. All banks grant housing loans, those accounting for almost 31% of all banking loans, granted to the individuals. An important feature of the Slovenian housing finance market is still a big role of the National Housing Fund (NHF), which is a public agency. However, in terms of new loans its role has been declining. Commercial and savings banks and the National Housing Fund (NHF), share the market in the relation of approx. 4:1 in terms of total outstanding housing loans as per the end of 2003. The agency primarily targets young families as customers; however, there is no strict separation from other lenders.

Mortgage housing loans

In the framework of the housing finance the role of mortgage loans is still relatively weak. Mortgage crediting is comparing to other European countries still relatively undeveloped in Slovenia. While the use of mortgage in financing corporate sector is widely used by banks this does not hold for non-corporate sector. Relatively weak ability of household sector to borrow against mortgage is depriving households of getting good access to credit facilities in housing finance. It is true that mortgages have recently started being more widely used in housing finance, yet their importance is still modest in comparison to that one in the Western Europe.

At the end of 2003, only 30.95 % of housing loans to consumers are secured by mortgages. Rather, the preferred collateral is loan insurance. The reasons of the banks preference of loan insurance towards entering a mortgage are long-lasting registration proceedings and problematic and lengthy foreclosure proceedings. The relative weight of mortgage changes if we take into account only banking housing loans. The reason lies in fact that the National Housing Found loans are almost not secured by mortgages. Mortgage loans account for approx. 38% of banking housing loans. The share has been continuously increasing over the past years what indicates that situation has been improving.

Looking only at the new lending the picture is somewhat better. In 2003 the skare of mortgage housing loans already surpassed 50%, what is important development if we know that the respective share in only few years ammounted only to 14% (year 1998). According to the recent Survey by the Ministry of Finance, banks are further planning to increase mortgage lending in housing finance. The share is expected to further increase in the following years after the completion of the land register project and improvements in foreclosure legislation.

Typical mortgage loan in Slovenia

Mortgage loan maturity is still relatively short. Loans with maturity of up to 10 years account 43% of all loans, the rest are loans from 10 up to 20 years. Long-term mortgage loans with maturity over 20 years are only now gradually emerging (according to the survey of MoF for 2003 they accounted for 1.7% in that year.

Table 4: Mortgage Loans outstanding in Slovenia by maturity in % (1998-2003)

	1998	1999	2000	2001	2002	2003
Up to 5 years	9.1 %	8.6 %	8.8 %	7.9 %	6.2 %	5.2 %
From 5 to 10 years	48.7 %	51.0 %	62.0 %	56.9 %	48.5 %	37.6 %
From 10 to 20 years	42.2 %	40.4 %	29.2 %	35.2 %	45.3 %	47.6 %

Source: Surveys of MOF, 2000, 2002, 2003 and 2004

Recently, major banks' business policies have done remarkable differences in terms of mortgage loans vis-à-vis other forms of housing loans (lower interest rates and longer maturity for mortgage loans). Banks are also expecting changes in legislation (land registry, foreclosure, mortgage banking act,). Once this comes into effect banks are planning to support even more mortgage lending with more financial and human resources. Banks estimate that the field of mortgage housing lending in Slovenia will be the field with the most rapid growth in the near future.

- Maturity: 45% - up to 10 years, 33% - 10 to 15 years, 11% - 15 to 20 years, 2% - over 20 years

- Loan to Value: 3 banks - up to 60%, 12 banks - up to 50%, 3 banks - up to 40%, 4 banks - up to 33% (Varies depending on location, customer, etc.)

- Interest rates: fixed or negotiable after two (five) years, inflation linked, recently banks also offer EURIBOR based loans

- Prepayed loans: costs 1.5 - 3% of outstanding loan

Secondary Mortgage Market

Currently, the secondary mortgage market is non-existent in Slovenia. Banks predominantly finance their mortgage loans via deposits, which are due to still not satisfactory stable macroeconomic environment relatively expensive source of financing and secondly, they are of very short maturity. Approx. 91.5% of all bank's deposits are of maturity of up to one year. This indicates quite a remarkable maturity transformation risk. Thereby banks expose themselves to serious maturity mismatches, which of course also reflect themselves in higher risk premiums building up interest rate spread.

Long-term funding instruments are needed in Slovenia to help expand maturities of mortgage loans. On the other hand banks need to transfer risks (liquidity risk, interest risk) arising from mortgage lending to capital markets. Development of secondary mortgage market in Slovenia is therefore of a very high importance for future development of mortgage banking and housing finance. However, this is a very complex process with many preconditions to be met beforehand. Firstly, the development of primary mortgages is a condition sine qua non for development of the secondary mortgage market. Secondly, introduction of the legislation on mortgage banks or mortgage bonds which will stipulate legal conditions for issuing of covered bonds is important for the transparency and safeness of the issuance of the covered bonds. Last but not least, Slovenia will also have to think about other necessary systemic preconditions for making covered bonds attractive enough to investors.

Drafting of the new Mortgage Bond and communal Bond Act is in final stage. The Act is expected to be submitted to the Government still this year.

Contract savings schemes

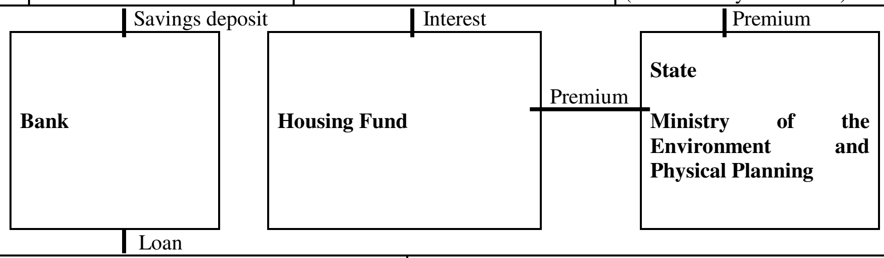
The *National Housing Saving Scheme* was introduced in March 1999 as the systemic basis for promoting long – term saving, including premium – granting for the purpose of increasing the extent of favourable long – term housing loans. For quite some time it was felt that the National Housing Found was not the "proper " institution for providing finance for owner-occupied housing, and that the NHF should concentrate its activity on the non-profit housing sector. Discussions on the actual institutional arrangements necessary for the financing of owner-occupied housing centered on the dilemma whether to introduce a specialized institution similar to the German Bausparkassen or simply to organise housing saving schemes within the existing banking system. The latter option was seen as less disruptive to the banks, as they were understandably not keen on being deprived of such an important and high quality source, as long – term deposits.

The National Housing Saving Scheme promotes long-term saving, making it more attractive by granting state-financed premiums and using bank interest for long-term savings deposits. Savers participating in this scheme can obtain a favourable housing loan, given that the banks are obliged to provide savers with a loan which must be at least double the sum they have managed to save and which is subject to a pre-set interest rate. The interest margin amounts to 0.8 per cent, which enables the banks to cover their operating costs incurred by the implementation of the scheme, where banks may not charge additional costs for approving the loan and for its management.

The system of granting state premiums to savers participating in the National Housing Saving Scheme in the form of adding a specific premium amount at the end of every year of saving increases overall return and thus makes long-term saving more attractive; it also promotes regular monthly saving. The state carries out the National Housing Saving Scheme via the Housing Fund and selected banks.

Table 5

SAVER	**5-year** saving period **10-year** saving period	Interest TOM (basic interest rate) + 1.65% TOM + 3.00%	Premiums 8.33% of annual payment annual (1 monthly instalment) 10.42% of annual payment annual (1.25 monthly instalment)



BORROWER based on saving	Housing loans 10 years – TOM + 2.45% More than 20 years - TOM + 3.80%

The right to a housing loan is transferable not only to spouses or partners but to children and grandchildren. Contracts on saving within the National Housing Saving Scheme began on 1 July 1999.

By 30 April 2000, 25,524 contracts had been concluded as part of the National Housing Saving Scheme, as many as 91.2 per cent for a period of five years.

4. Regulatory Structure

For an asset to serve as collateral, it must be possible as a last resort for the lender to have swift and sure access to ownership of the asset upon non-payment by the borrower. Effective foreclosure and eviction procedures, a sound registration system, and mortgage banking regulations are required for the emergence of efficient mortgage finance for real estate.

All above-mentioned conditions are still not fully met in Slovenia. There are already some relevant pieces of legislation in place, however some important are still missing. The major impediments to development of mortgage loan market in Slovenia are:

- Registration system (Land register)
- Still long lasting foreclosure procedures;
- Non-existence of effective mortgage banking legislation

The land register has been in place for more than two hundred years. The problem, however, is integrity of the register and the fact that the registry is not fully up to date. Also, foreclosure and eviction procedures in cases of not registered real estate are not so clearly and detailly stipulated by the law. So, creditors find themselves in even worse situation in the case that the borrower is unable to repay the loan than in cases that the real estate is registered. As also mentioned procedures to enter real estate and of signing a mortgage are very lengthy and also relatively expensive. With The Land Registration and Modernization Project, which is currently underway in Slovenia, Slovenia has got this year - 2004 fully computerized land register. It is foreseen that by the end of 2004, the longest waiting period for the registration with the Land Register will be six days;

As regards effective foreclosure procedures Slovenia adopted relatively modern legislation few years ago which substantially improved the position of lender in the case of default of the borrower.

Nevertheless, the banks still report relatively long procedures in practice (up to two years) and many of them still feel that legislation is protecting borrowers more then lenders.

With the aim of further improvement of the position of the lender the Act Amending the Execution of Judgments in Civil Matters and Insurance of Claims Act was adopted in 2002. The Execution of Judgments in Civil Matters and Insurance of Claims Act governs the rules of procedure pursuant to which the courts perform compulsory execution of claims on the basis of executive instruments and authentic documents and the rules for interim protection of claims, and regulates the office of execution officer.

Proceedings for execution and/or interim protection shall be instituted upon an application by the creditor/lender and in cases prescribed by the statute; proceedings shall also be instituted by virtue of office. If not otherwise stipulated, district courts shall have the power to permit execution and the interim protection of claims. Immediate acts of execution and the protection of claims shall be performed by execution officers, unless otherwise prescribed by the law. In the event that more than one creditor raises money claims against the same debtor and upon the same property subject to execution, those claims shall be satisfied in the order in which the creditors acquired the right to have their respective claims paid from the property in question. Court proceedings in matters of execution and the interim protection of claims shall be conducted without delay.

The important achievement in the field of the Slovenian civil law, for it consistently regulates the classic real property law, is the adoption of the Real property Code in September 2002.

The Real property Code regulate the basic principles of *real property law*, *title* and *real property rights* and the ways of their acquisition, transfer, security and discontinuance. Apart from the general provisions of real property law, the Code also includes provisions belonging to the general part of civil law.

The Code regulates comprehensively and anew *the issue of real property right* and of other rights, the underlying foundation of regulation being the concept of private property. It is also aimed at filling the gaps in the legal regulation of individual real property rights (personal easement, real burdens, *land debt*, the *superficies solo credit* right). The Code also set out the real property law institutes (the concept of movable and immovable property, fixings, etc.).

It also includes a *chapter on condominiums*. An important novelty is the introduction of an obligatory reserve fund. The reserve fund will provide at least the minimal material basis for implementing management measures in multi-apartment houses. Lien is comprehensively regulated as well. Up to now, its regulation has been divided among three acts: the Basic Property Law Relations Act, the Obligations, and the Execution of Judgments in Civil Matters and Insurance of Claims Act.

The *institute of the land debt* is another novelty in the Code. It has been adopted from the German real property code and represents a new possibility, together with the mortgage, to use land as collateral. The land debt has all the features of a mortgage. The difference lays in its independence from the existing liability protecting it.

An important novelty introduced in the Slovenia study of law is the *superficies solo cedit* right. It implies the discontinuance of the fundamental principle of real property law – the unity of title to land and building. In the social ownership system, only the right to use the land in social ownership (land always belonged to the owner of the building) established itself as a specific right. The superficies solo cedit right implies the separation of title to land from title to a building, where the owner of the land and the person developing the land sign a contract stipulating the ways of compensation and the duration of the superficies solo cedit right. The superficies solo cedit right will bring benefits to both the owner of the land, who does not want to sell it and will in a way obtain an income from the land, and the holder of the superficies solo cedit right, who will find the contraction easier to complete.

The adoption of the Real Property Code has brought many novelties and benefits in the field of real property law and has met the requirement stipulated by the constitutional system of the Republic of Slovenia, which regards private property as one of the fundamental rights guaranteed by the Constitution. After the year 1991, Slovenia introduced significant systemic changes and the adoption of the Code was a necessity, because it pursues the concept of private property and is comparable to the codifications of real property law in other countries

Code of Obligations, adopted in 2001, defines general characteristics of obligations and regulates the contractual relations between legal subjects in line with the equality principle. The securities Act defines bond, regulates who can issue bonds, what are major elements of a bond, and how the bond can be traded.

5. Housing Policy

5.1. Government Policy for Own-Housing

The respective Slovene statutory regulation consists of:

- updated Construction Act (2002), stipulating provisions for building design, methods and procedures for obtaining building permits and construction; it provides the adoption of 13 executive regulations.

- updated Spatial Planning Act (2002), defining types, contents, hierarchy of documents, and the method of their preparation. It also defines the instruments for the operational planning of development activities. It regulates spatial planning activities and the enforcement of implementation measures for the implementation of the planned spatial arrangements; it provides the adoption of 18 executive regulations.

- updated Construction Products Act (2000) which lays down conditions for the sale of construction products; it provides the adoption of 7 executive regulations;

- updated Housing Act (2003), regulating the types of residential buildings, conditions for maintaining residential buildings, conditions for planning dwellings, ownership relations and the management of multi-family buildings, rental housing relations, the construction and sale of new dwellings, help in obtaining and in the use of dwellings, the presence and tasks of the state in the housing field, the competencies and tasks of municipalities in the housing field; it provides the adoption of 11 executive regulations;

- Real Estate Brokerage Act (2003) which defines conditions for real estate companies and real estate brokers for brokering real estate transactions, establishes the rules for safe and diligent business activity in real estate brokerage that real estate companies and real estate brokers are obliged to respect in their work; it provides the adoption of 5 executive regulations.

Financial incentives (loans) for the provision of owner-occupied housing

One of the most important instruments in support of increased housing construction is the housing loans offered by the National Housing Fund (NHF). During the last 10 years the NHF offered more affordable loans (i.e. with lower interest rate) than the commercial banks. Priority is given to young families, families with many children, families with unemployed persons, disabled persons, etc. Up to now the NHF has provided housing loans to more than 30,000 citizens.

Financial (savings) incentive for the provision of private housing

In the year 2000 the National Housing Savings Scheme (NHSS) was approved by the National Assembly. The scheme enables and sets up interest rates, annual premiums and a possibility of taking an affordable housing loan at the end of the contract (savings) period in the scheme. The overall demand for participation in the NHSS has been very high since the initiation of the scheme (1999), with up to 80,000 savings contracts having been concluded. The housing sector is regulated by building regulations, the Housing Act and the National Housing Programme. The policy maker is Ministry of Environment, Spatial Planing and Energy and municipalities on the local level.

5.2. Government Policy for Rental-Housing

Housing Act (2003), regulating rental housing relations, rents especially non-profit rents, provides the adoption of 11 executive regulations – one of them is *Metodology to model non-profit rents*.

Financial incentives for the provision of non-profit rented housing

The other financial instrument available from the NHF is the availability of affordable housing loans for non-profit housing organisations. About 2,900 non-profit rented dwellings were built through the provision of these loans.

Partnership between the state and local authorities

One of the innovative instruments in support of housing provision is the partnership between the state and local authorities. The local authorities (municipalities) own the building land for the purpose of housing construction but often lack the financial resources. Cooperation is therefore needed between the National Housing Fund and the interested municipalities to join forces in the provision of funds and land for housing construction in order to provide new quality housing in compliance with the minimum technical requirements for the construction of residential buildings and dwellings.

Subsidies

At the moment there are two types of subsidies in Slovenia: “object” subsidies and “subject” subsidies. Object subsidies are intended for owners of rented dwellings and subject subsidies for tenants of rented dwellings, including social-rented and nonprofit-rented dwellings. In the year 2005, a new and effective system of subsidising rents (rent allowance) to low income tenants will be introduced. The new system enables a more elastic check on ability to pay rent adapted to the specific circumstances of the tenant in question. The proposed system of subsidy is designed in such a way that it guarantees a tenant an adequate subsidy in relation to their income. It is estimated that between 10,500 and 12,000 tenants will receive such rent allowance, which is a substantial increase on previous numbers of recipients (around 2,700).

5.3. Housing Taxation

The VAT on the construction of non-profit housing is only 8.5% as compared to the general taxation level of 20%. The taxation caused by transferring home-ownership to others is 2% of the value.

5.4. Urban Development, Land and Other Policies

Definition of urban growth areas

Recently adopted new spatial planning law requires that each local community defines urban growth areas. It is assumed that outside the urban growth area the development will take place only in cases specified by law. The aim of the measure is to reduce urban sprawl which has strongly characterized the development of urban region after the 1990. The housing sprawl has been followed by new shopping malls at the city outskirts and has generated rapid increase in private motorization.

The legal framework has been established and local communities are drafting a new generation of local plans. At the moment it is not possible to evaluate the effects of the measure. We assume that the measure might increase the land prices and push affordable housing further out of the town if adequate land policies will not be in place at the right time.

Land development charges according to infrastructure development costs

Local communities will charge developers the infrastructure development costs according to the estimated building costs. We assume that charging real costs might decrease the pressure on locations far from the regional centers. Up to now it was less expensive for the developer to build housing on Greenfield location although the cost for the communities where higher than on Brownfield locations. We assume that land development charges are high enough to put a brake on further sprawl.

The bylaw has been adopted by the Government and the Ministry has set up a training program which will help the local communities in the transition toward the new system of land development charges.

NOTES

1 Like Slovenia, the EU countries recorded the lowest economic growth after 1993 in 2003.

2 Pursuant to amendments to the Employment and Insurance Against Unemployment Act, Rules on the Contents and Method of Keeping Public Employment Records were adopted in October 2002, determining the criteria for the transfer of people from unemployment registers to registers established in accordance with other laws. These criteria were laid down by the Employment Service of Slovenia (ESS) in co-operation with the competent institutions referred to in each particular law. The transfer to other records is based on an employment plan. In accordance to these Rules, the ESS, in co-operation with the Pension and Disability Insurance Institute (PDII), prepared a regulation for disabled workers – recipients of the PDII's disability allowance. The institutes began to examine the employment prospects of disabled workers and establish the criteria for their transfer to unemployment register based on other laws. The following categories were taken into consideration: (i) people registered at the ESS for at least two years; (ii) people who were sent to employers but failed to get a job due to disability; (iii) people for whom no suitable jobs were available during the period; and (iv) people who remained jobless even after having participated in the active employment policy programme.

3 A new programme aimed at achieving strategic goals in the area of labour market and employment in 2005, to be distinguished from the equally titled programme adopted by the government in December 2003 for the implementation of employment goals in 2004.

4 The Harmonised Index of Consumer Prices (HICP) is based on the composition of expenditure of residents and non-residents in Slovenia, while the Consumer Price Index (CPI) is based on expenditure composition of Slovenian residents. Due to the different weighting of goods and services, the values of the two indices differ; however, the difference in average inflation measured by both indices did not exceed 0.1 p.p. in the past two years.

CHAPTER 9. HOUSING FINANCE IN CROATIA

by

Mladen Mirko Tepus*

Introduction

The Republic of Croatia is a sovereign, independent republic, established as a parliamentary democracy since 1991. Its governing structure is based on a principle of the distribution of power among the legislative authority (the Croatian parliament), executive authority (Government of the Republic of Croatia) and judiciary (municipal courts, country courts, commercial courts, the High Commercial Court, the Administrative Court and the Supreme Court). The power is decentralized by virtue of the constitutional right to local and regional self-administration. The country's territorial organization includes 20 counties and the City of Zagreb (capital) with a total of 123 towns and 425 municipalities.

As a new independent country Croatia is going through a complex process of transition toward a market economy. The main objective is the establishment of a welfare state and to achieve it, it is necessary to improve the efficiency on the macroeconomic as well as the microeconomic level as much as possible, and to raise the living standard and reduce inequality among citizens.

The living standard, housing financing models, their supervision and the policies related to this issue are presented further on in this paper.

Table 1. Land Indicators

Land area (km^2)	56,542	Residential land (km^2, % of the total):	7.65%
Coastal sea (km^2)	31,067		
Islands:	1,185	Inhabited Islands:	47
Capital:	Zagreb	National currency:	Kuna (HRK)

Soucre: Central Bureau of Statistic

Croatia is among the countries with the longest tradition of urban planning, and physical planning is described as a field of construction that has been regulated for more than 30 years. The organization and development of towns has been influenced predominantly by the Mediterranean and Central European culture. All major settlements have to have urban development plans. The future development of settlements and construction-designated areas is part of the country's physical planning strategy and programmes. Croatia, like the EU members, is a signatory of the European Landscape Convention and has passed legislation ratifying it.[1]

The urban organization displays some irregularities: small towns are predominant, regional centres lag behind the capital while some regions have no large urban centres at all. Since a few years back, a number of physical plans of towns have been abrogated for various reasons. Such a situation has

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helped spawn unplanned and illegal construction in towns and tourist settlements that is considered a criminal act under the latest legislative amendments, which also preclude the possibility of providing such illegally erected structures with the basic public utilities. The decisiveness of the new Government to bring order is reflected in the amendments to several laws that regulate this field and also in demands for the relevant authorities to draw up physical plans, in comprehensive inspection checks and numerous campaigns to remove illegally built structures all over the country (in 2004, the competent ministry has had 200 such structures demolished and plans to have another 50 demolished by the end of the year, while the owners themselves demolished a number of other such buildings). In order to amend and improve the current situation, the Government established a State Physical Planning Council, which is in charge of reviewing and coordinating physical plans of local self-administration units, counties etc. The general urbanization level (ratio of town residents to the total population) stands at 51.09% and is expected to rise further. In line with the trend, the urbanization level is expected to reach 75-80% by 2015. The average population density is relatively low at 78.39 residents per sq km. The fact that towns represent the main hubs of employment is among the reasons that 16% of the total population lives in the metropolis. Out of the total housing units in 2003, 67.03% were in towns and 15.6% of the total population were day migrants (or commuters).

Table 2. Population Indicators

		1999	2000	2001	2002	2003
Population	(thousand people)	4,554	4,381	4,437	4,443	4,442
	(% change)	-0.04	0.01	0	0	-
	Population density (inhabitants/km^2)	80.5	77.5	78.4	78.5	78.5
Labor force	(thousand people)	1,730	1,894	1,767	1,792	1,793

Soucre: Central Bureau of Statistic

Note: Labor force: working age population according to ILO (International Labor Organization) standard

Croatia's demographic picture based on the facts collected in the 2001 census can be described as less than satisfactory, senior citizens prevail in the population and the number of deaths exceeds the number of births (the population is shrinking).[2]

Table 3. Macro Economy

		1999	2000	2001	2002	2003	6/30/2004
GDP (at current prices)	(million USD)	19,906	18,427	19,863	22,436	28,335	-
Real GDP growth	(% change)	-0.9	2.9	4.4	5.2	4.3	-
GDP per capita	(USD)	4,371	4,206	4,477	5,050	6,377	-
Unemployment rate	(% of labor force)	20.4	22.6	23.1	21.5	19.1	18.6
Inflation rate	(in % end of year)	4.2	6.2	4.9	1.7	1.8	1.9
Gross savings rate	(% of GDP)	37.4	48.4	63.1	77.6	82.9	-
Monthly average net wages	(in USD)	427	429	429	537	661	693
Exchange rate	(HRK : USD)	7.6477	8.1553	8.356	7.1457	6.1185	6.0579

Soucre: Central Bureau of Statistic and Croatian National Bank

The Croatian economy recorded solid growth in 2003 (slightly weaker than a year earlier) which, along with the external debt (reaching 51.6% of GDP) and balance of payments and fiscal deficits, was the main characteristic of the macroeconomic situation. Construction was the activity with the strongest growth, primarily thanks to intense investment in the road infrastructure (motorways) that was stressed as a top priority of the Government's economic programme. The industrial output index rose 4.2% compared to 2002 (having risen 5.4% in 2002 over a year earlier). Tourist seasons of the past few years have brought an increase in the number of tourists (by 7% in 2003 and 6% in 2002) and foreign exchange receipts (the Croatian National Bank (CNB) estimates their increase at 67% in

2003), and such developments are expected to continue in the future. The 2003 consumer price index recorded an increase by 1.8%, with goods prices rising 1.6% and services prices 2.5%. Among the monetary developments it is interesting to point out that the CNB enforced certain measures in 2003 aimed at curbing the credit expansion (after a 33.6% credit expansion in 2002), so 2003 credits grew 11.3% (with the financial activities of non-banking institutions, e.g. leasing etc. growing at the same time). Also, there has been an evident increase in the credit exposure to households (household credits rose 43% in 2002, and 27.7% in 2003). The unemployment rate has fallen slightly, while the average net wages have risen. The manufacturing industry (electrical machinery and appliances) accounts for 94.5% of the total merchandise exports, with the European Union countries being the main foreign trade partners (with more than a 50% share).

Table 4. Overview of Croatia's Credit Ratings

	Long term rating Foreign currency	Long term rating National currency
Moody's Investor Service	Baa3 /stable "outlook"	Baa1
Standard & Poor's	BBB-/stable "outlook"	BBB+
Fitch Ratings	BBB-/positive "outlook"	BBB+
R & I	BBB	-

Soucre: Ministry of Finance

This April, Croatia was received positively by the European Commission. It became an official EU candidate in June, and the negotiations on accession to EU should start in March 2005.

1. Housing Supply and Demand

The data available on the number of housing units, households and population might lead to a conclusion that there is no lack of housing. However, even a rough analysis shows an evident overpopulation of a number of dwellings (as several households sometimes inhabit the same dwelling) as well as a considerable shortage of housing in large centres/towns, low housing standard (the average housing area was just 27.6 sq m per person in 2001, etc.)[3] and strong demand for social housing, while a number of dwellings are in need of renovation (e.g. 7.2% of inhabited dwellings lack sewage, 6.3% have no water supply and some 14% have no WC or bathroom). All this considering, the demand for the purchase and renovation of housing is expected to grow in the future, and so is the demand for home financing.

Table 5. Housing Stocks

		1961	1971	1981	1991	2001
Dwellings	(thousand units)	-	1,219	1,480	1,772	1,877
	Growth rate (%)	-	-	21.4	19.7	5.9
Dwellings for permanent residence	(thousand units)	-	1,189	1,381	1,576	1,661
	Growth rate (%)	-	-	16.2	14.1	5.4
Households by Censuses	(thousand)	1,168	1,289	1,424	1,544	1,477
	Growth rate (%)	13.2*	10.4	10.5	8.4	-4.3
	Average number of persons per household	3.6	3.4	3.2	3.1	3.0
Inhabited dwellings with:	(One household; thousand)	-	1,072	1,261	1,405	1,366
	(Two household; thousand)	-	66	56	45	40
	(Three or more household; thousand)	-	15.2	8.4	3.3	2.7

* calculated to the previous census in 1953

Soucre: Central Bureau of Statistic

Table 6. Housing Stocks by Construction Year

HOUSING CONSTRUCTION YEAR		UNKNOWN	~ 1970	1971-1990	1991-2003	TOTAL
Housing stocks by construction year (thousand units)		49	674	574	119	1,416
Composition ratio	(%)	3.5	47.6	40.5	8.4	100

Soucre: Central Bureau of Statistic

Notes: Composition ratio shows the ratio of respective housing stocks to the total stocks in year 2003 (=100).

Table 7. New Construction

			1999	2000	2001	2002	2003	6/30/2004
Completed buildings	Total	(units)	1,762	1,341	1,795	2,229	n/a	n/a
	Residential buildings	(units)	1,389	955	1,439	1,872	n/a	n/a
	Office buildings	(units)	50	46	41	45	n/a	n/a
Completed dwellings	Total	(units)	12,552	17,487	12,862	n/a	n/a	n/a
	Dwellings for permanent residence	(units)	12,175	15,988	12,580	n/a	n/a	n/a
Housing trading volume		(thousand units)	782	1,036	1,028	957	1,436	1,028

Soucre: Central Bureau of Statistic

Notes: 1. Completed buildings means the construction built by legal entities employing 5 or more persons that are main constructors

2. Housing trading volume means the number of traded housing stocks.

The current demand for rented housing is estimated at 6,900 social and 4,000 non-profit units, and the waiting time for these is quite long. War damage during the recent aggression on Croatia contributed to an erosion of the housing standard as 135,000 dwellings were destroyed between 1991 and 1994, worsening the living conditions of numerous displaced persons and refugees. A total of 12,580 units were completed in 2001, down 21% compared with 2000, while the number of dwellings built since 1996 is largely a result of the renovation of housing destroyed or damaged during the war. The number of dwellings built each year still lags behind the pre-war period (in the 1980s, 20-30,000 units were being built annually). Resolving housing problems of the Homeland War victims and the reconstruction of destroyed dwellings was set as a priority of the housing crisis resolution. All the structures damaged in the war should be rebuilt by 2006 as part of a programme entitled “A Roof for Each House”. The rented housing market is poorly organized and the exact number of tenants is difficult to determine as a large number of people who let housing do not report this officially in order to avoid paying tax. Around 37,000 households in Zagreb alone (or 13.5%) have the status of lessees (tenants), paying a monthly rent of 5-7 EUR per sq m[4]. Furthermore, large cities have a considerable number of dwellings with several rooms inhabited by the elderly, so this points to insufficient and inadequate programmes of care for senior citizens.

Table 8. Demolished Dwellings

		1999	2000	2001	2002	2003
Demolished dwellings	(units)	450	784	575	687	-

Soucre: Central Bureau of Statistic

The first signs of stabilization in the region following the Homeland War brought about a considerable increase in housing prices. The average price per sq m of housing in 2003 was between 10,241 kuna (in Zagreb area) and 7,033 kuna (in other towns), while the average monthly net wage totalled 3,940 kuna. A comparison of these amounts shows that an average citizen needed 1.8 – 2.6 monthly net wages for the purchase of a square metre of housing, i.e. financing the purchase of one's own flat or house from the regular income is impossible.

Table 9. House Prices and Financing Indicators

		1999	2000	2001	2002	2003	6/30/2004
Housing price	(domestic currency, average)	9,004	8,688	8,306	8,366	8,569	8,453
	(% change)	-	-3.5	-4.4	0.7	2.4	-1.4
Housing price index		-	-	-	-	-	base date: -
Long-term credit rate (fixed market rate)	Indexed loans to EURO (%)	-	-	-	-	7.5	7.5
Long-term credit rate (adjustable market rate)	Indexed loans to EURO (%)	10	9-9.5	9-9.5	7.5-9	6.9-8.9	6.8-8.5

Soucre: Central Bureau of Statistic and Internet

Notes: 1. Mortgage rate is a base rate of most popular fixed rate loan product with longest maturity, provided by the major mortgage lender.
2. Long-term credit rate is a base rate of longest-term loan provided by major commercial bank.

The latest figures released indicate an increase in the prices of housing in Zagreb and on the Adriatic as a lot of foreign buyers have appeared alongside local buyers, so a number of analysts predict that the prices will increase further. Despite the price increase, the number of housing units sold over the past year has risen significantly. According to the information available to the Author of this paper, almost 70% of these units were small flats (maisonette or bed-sit type, one-room flats), their prices rose most and 80% of them were financed by housing loans.

In the absence of one's own funding, housing may be bought and financed by borrowing on the financial market. However, a large number of average Croatian citizens cannot meet the current criteria of commercial banks – the single market creditors providing long-term housing loans immediately.

2. Housing Finance Market and System

Organized housing financing in Croatia is the business of commercial banks and housing savings banks. Commercial banks often participate in home financing together with housing savings banks, and their products are included in various housing models (e.g. the government-subsidized POS model).
The ratio of approved housing loans to the Gross Domestic Product in Croatia was 9.85% at the end of 2003, or relatively low compared to the European Union average.[5]

Table 10. Distribution of Granted Home Loans by Financing Model

		1999	2000	2001	2002	2003	6/30/2004
TOTAL HOME LOANS	(in mil. USD)	976.70	1,012.64	1,132.31	1,742.96	2,792.20	3,086.38
	(change in %)	-	3.68	11.82	53.93	60.20	10.54
	(%)	100.00	100.00	100.00	100.00	100.00	100.00
Market share - Banks	(%)	100.00	99.99	99.88	99.27	98.90	98.55
Market share - Housing Savings Banks	(%)	0.00	0.01	0.12	0.73	1.10	1.45
GDP	(in mil. USD)	19,906	18,427	19,863	22,436	28,335	-
Home loans / GDP	(%)	4.91	5.50	5.70	7.77	9.85	-

Source: Croatian National Bank

Basic data on housing financing products of the main creditors are shown in the table below.

Table 11. Mortgage Products

Major products	Method of payment	Loan interest rates	Maturities	Borrowers	LTV	Others
1. Home loan of Commercial bank	Monthly installments (amortization)	6.45-8.50% (adjustable)	mostly 15-20 years (possible up to 35 years)	Higher&middle - income households	up to 100%	Maximum payment/income ratio = 1 : 3; average loan amount 40,000-50,000 EUR; indexed to the EURO; deposits are requested (10-20%); co-borrowers (1 or 2) and guarantors (1 to 3) are requested ; real estate as collateral (1:1.3); loan fees 0.5-1.5% of the loan
2. Home loan of Housing Savings Banks	Monthly installments (amortization)	4.44-6.0% (fixed)	up to 20 years	Households	up to 100 %	Controlled use of funds; co-borrowers (1 or 2) and guarantors (1 to 3) are requested; real estate as collateral (1:1,5); deposit is requested (30-50%); indexed to the EURO; loan fee 1%

2.1. Housing financing by commercial banks

Along with the process of establishing its independence the Republic of Croatia also embarked on a reform aimed at building an efficient, market-based financial system, transparent by international standards. The first step in that direction was the adoption of the Bank and Savings Bank Act in October 1993[6] that enabled the establishment of banks and savings banks. Until then banks' operations were regulated by a law taken over from former Yugoslavia, under which a market-oriented banking system reform of limited scope was initiated in 1989. The October 1993 Bank and Savings Bank Act remained in force with minor amendments (passed in 1996) until 1998, when it was replaced by a Banking Act[7]. In 2002, a new Banking Law[8] was passed. The early banking regulations were drafted after those in Germany, while also taking into account quality solutions found in other countries. However, the inherited and current state of affairs at the time did not enable a complete "copying" of foreign models. The proposed legislation could not be such as to cause major "breakdowns" within the banking system, but at the time its provisions were supposed to influence banks to develop their business in line with the market rules.[9] After the Bank and Savings Bank Act was adopted in October 1993, universal-type commercial banks began to be founded and they nowadays represent the most developed type of local deposit financial institutions. The development of commercial banks has gone through various stages, and Croatia also had two banking crises.

Most recently, the banking system has been characterized by a consolidation (numerous bank mergers and mergers of banks and savings banks), and an increasing representation of foreign-owned banks in the total banking sector assets.[10]

Under the current, July 2002 Banking Law, the banks' main service is the receiving of money deposits and the granting of loans and other placements from the deposit funds on their own behalf and for their own account, and the issuance of other payment instruments in the form of electronic money. Apart from banking services, banks may also provide other services with a prior consent of the Croatian National Bank. A minimum share capital of banks is set at 40 million kuna (6.6 million USD), and they may only be established as joint-stock companies. The same law regulates in detail the terms under which banks may be founded and operate, as well as their supervision by the Croatian National Bank, the circumstances under which their licence may be revoked etc. Savings deposits of up to 100,000 kuna (16,507 USD) held by commercial banks have a 100-percent coverage on the principle of mandatory deposit insurance of the State Agency for Deposit Insurance and Bank Rehabilitation.

There were 41 active commercial banks in Croatia at the end of 2003, and 33 of them had credits to households related to the housing loans granted to them.[11] Banks that do not engage in housing financing (8 of them) are smaller banks with individual assets of less than 700 million kuna, while their combined assets represent 1.04% of the total banking sector assets. At the end of 2003, the share of housing loans approved by commercial banks in their total assets amounted to 8.10%.

Total consolidated commercial banks' assets at the end of 2003 reached 195.3 billion kuna and stood 17.9% higher compared to 2002, or 77.6% higher compared to 2000.

With respect to the subject of this paper it is interesting to note that in 2003, receivables from households rose by 27.7% compared to 2002, or by 136.1% compared to 2000. Total credits to households included housing loans.

The Croatian banking system is characterized by a significant presence of large commercial banks. The two largest commercial banks by asset size (Zagrebačka Banka d.d. and Privredna Banka Zagreb d.d.) account for 42.7% of the total banking sector assets, while 8 largest banks account for 82.9% of the banking sector total. The same 8 largest banks by assets size granted 88.65% of the overall housing loans reported at the end of 2003.

There is no organized trade in housing loans in Croatia, and banks engage in housing financing as portfolio lenders. Commercial bank encounter numerous problems related to housing loans, the most significant of which are an information asymmetry, i.e. insufficient information on retail clients (a credit register was established in 2003), and difficulties related to the valuation and use of collateral (property assessors, in bankers' opinion, are not focused enough on the market value; collection by seizure and sale of mortgaged property is difficult to implement and very often takes a long time).

Table 12. Banks' Accounts, in million kuna

	1993	1997	2000	2002	2003
ASSETS					
1. Reserves with the CNB	861	5,046	10,589	20,373	26,784
2. Foreign assets	6,212	16,186	19,710	25,978	35,383
3. Claims on central government and funds	19,972	15,239	19,055	21,918	21,544
4. Claims on other domestic sectors	20,262	48,592	60,364	96,218	110,374
4.1. Claims on local government and funds	11	309	1,175	1,422	1,563
4.2. Claims on enterprises	18,348	35,487	35,891	51,723	53,810
4.3. Claims on households	1,902	12,796	23,298	43,073	55,001
5. Claims on other banking institutions	10	–	69	219	432
6. Claim on other financial institutions	16	247	162	915	762
Total (1+2+3+4+5+6)	47,332	85,309	109,949	165,622	195,278
LIABILITIES					
1. Demand deposits	1,759	8,424	11,386	21,166	23,315
2. Savings and time deposits	1,466	5,599	7,651	13,001	18,371
3. Foreign currency deposits	5,412	31,278	46,902	72,055	76,035
4. Bonds and money market instruments	48	134	478	216	598
5. Foreign liabilities	12,066	13,807	17,810	35,023	49,932
6. Central government and funds, deposits	1,438	6,875	6,730	6,095	5,283
7. Credit from central bank	275	34	329	18	969
8. Restricted and blocked deposits	14,262	5,852	2,550	1,680	1,709
o/w: Households, blocked f/c deposits	13,857	4,574	1,695	319	168
9. Capital accounts	11,203	17,027	24,953	26,323	27,389
10. Other items (net)	–597	–3.720	–8.839	–9.956	–8.324
Total (1+2+3+4+5+6+7+8+9+10)	47,332	85,309	109,949	165,622	195,278

Source: Croatian National Bank

Table 13. Structure of Bank's Loans by Institutional Sectors

	1999	2000	2001	2002	2003	6/30/2004
Government units	6.41	8.01	6.59	7.26	7.76	7.89
Financial institutions	2.42	2.12	2.25	2.34	2.78	2.13
Public enterprises	3.73	4.60	4.43	4.09	3.67	3.91
Other enterprises	48.86	43.58	43.48	40.94	37.36	36.64
Non-profit institutions	0.44	0.57	0.25	0.33	0.31	0.30
Households	37.10	40.57	42.48	44.51	47.76	48.86
Non-residents	1.05	0.54	0.52	0.53	0.36	0.27
Total credits (%; mil. USD)	100.00	100.00	100.00	100.00	100.00	100.00
	6,095	6,280	7,884	12,916	17,995	18,712

Source: Croatian National Bank

It is evident from the share of housing loans in the total household credits that the absolute amount of these loans as well as their relative share in the portfolio of commercial banks is growing. The reasons for such developments lie in the following: stable growth of long-term savings deposits, fall of the interest rates charged by banks on housing loans, rise of living standards, loan security (loan service by retail clients has proven the best), improvements in property rights and judicial practice (e.g. fiduciary rights) etc.

Table 14. Overview of current Banks' Home Loan Terms

BANK:	Interest rate		Effective Interest Rate – EKS (%)	Repayment period (years)
	%	Type		
Zagrebačka Banka d.d., Zagreb	6.80 – 7.50	adjustable	6.84-7.86	up to 30
	7.49	fixed	7.54	up to 25
Privredna Banka Zagreb d.d., Zagreb	6.98 – 7.48	adjustable	7.82-8.84	up to 30
Raiffeisenbank Austria d.d., Zagreb	7.50 – 8.50	adjustable	9.22-9.50	up to 25
Erste & Steiermärkische Bank d.d., Zagreb	(4.99*) 6.45 – 6.95	adjustable	(5.64*) 7.38-7.28	up to 30

* Interest rate for loans indexed on Swiss franc. All the others are on loans indexed on EURO

Source: Internet, researched on August 08, 2004

Housing loans are currently offered on the local financial market at a nominal interest rate of between 6.45 and 8.50% (i.e. effective interest rate of 6.84 to 9.50%[12]) annually, and various credit worthiness criteria are applied. The main criteria for obtaining a housing loan are a borrower's income (salary size) and the quality of the company he/she works for (the stability of its business is assessed). Depending on these criteria additional requirements may also be made (a borrower's own participation; co-borrowers and/or guarantors with appropriate income; certain type and amount of collateral – most often a housing unit worth at least as much as the loan amount to be approved[13], life insurance policy of the borrower tied over to the bank etc.).

Recently, some banks have issued housing loans indexed to the Swiss franc, thereby promoting lower interest rates and others have granted loans under a repayment-free model, with nothing but the interest repayable over the loan period while the respective share of matured principal is paid into an investment fund. Such products represent an innovation on the local housing loan market and their supply is limited.

Refinancing housing loans from more favourable resources has had negligible scope in Croatia so far, although housing loan contracts include the clauses that regulate this issue, mostly providing for the payment of a certain fee. However, such a state of affairs is definitely influenced by the widespread practice of Croatian banks which, prior to approving housing loans, require that borrowers open current accounts with them for the payment of their whole salary (or other regular income) and do not approve housing loans before a certain period has elapsed (usually three months). Therefore, the choice of a bank to apply to for a housing loan does not depend exclusively on loan terms. Nevertheless, there has been some liberalization of loan terms in that respect as well lately, and it is sure to continue in the future.

Banks use their own networks of branches and outlets (these totalled 1,022 at the end of 2003) as the main distribution channel for housing loans, while the Internet is used first and foremost to inform clients on loan terms and documents that are necessary. Banks have yet to develop external credit brokers as a distribution channel for loans. Some banks have opted to operate through such arrangements and we may expect this distribution channel to see further improvements in the future.

The characteristics of housing loans granted by commercial banks in Croatia are very similar, so we may speak about a certain standard of primary housing financing set by the banking industry which is applied throughout the country. For now, there have been no housing loans with the credit characteristics adjusted to particular groups of retail clients (so-called hybrid housing loans etc.) although there is scope for developing such products (e.g. for people who let private villas in the residential parts of towns and as well as numerous rooms and tourist apartments along the Adriatic coast etc.).

In view of a multiple effect of banking products that finance private housing projects (as a component of the total cost, project feasibility factor etc.) it is necessary to point out, as part of the subject matter of this paper, that such products with their characteristics (loan period, required documents, collateral etc.) are very often not adjusted to the needs of entrepreneurs. This ultimately translates into less favourable terms for buyers as it also raises housing prices.

To finance housing loans, Croatian banks do not yet issue mortgage bonds (European model) or mortgage-backed securities (Anglo-Saxon model), nor do they raise funding for this particular purpose in any other manner. The main sources of their housing funding are deposits and their own capital, with the EBRD special-purpose deposits and long-term syndicated loans used by some banks also worth mentioning.

Table 15. Funding Instruments

OUTLINE OF THE SYSTEM & CHARACTERISTICS	MAJOR ISSUERS	MAJOR INVESTORS (customers)
Mortgage Bonds	-	-
Contractual Savings Schemes - HSB	Housing Savings Banks	Households
Mortgage-Backed Securities	-	-
Others	Selective deposits	EBRD
	Syndicated loans	-

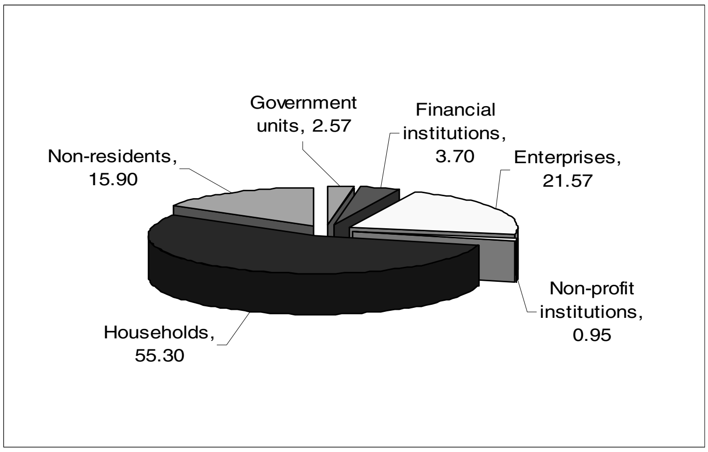
Table 16. Issuance Volume / Savings Volume

		1999	2000	2001	2002	2003	6/30/2004
Mortgage Bonds	(million USD)	-	-	-	-	-	-
	(number of transaction)	-	-	-	-	-	-
Contractual Savings Schemes - HSB	(million USD)	11.5	53.7	136.1	281.7	533.7	574.1
	(number of transaction)	-	-	-	-	-	-
Mortgage-Backed Securities	(million USD)	-	-	-	-	-	-
	(number of transaction)	-	-	-	-	-	-
Others	(million USD)	-	-	-	-	-	-
	(number of transaction)	-	-	-	-	-	-

Source: Croatian National Bank

Most savings at commercial banks are denominated in foreign currencies (foreign currency deposits account for 30% of the total liabilities in the consolidated balance sheet of commercial banks) and are mostly household deposits. Toward the end of 2003, household deposits made up 55.3% of the total deposits.

Figure 1. Distribution of Deposits by Sectors (in %)



When raising housing loans, retail clients are required to make a deposit of 10-20% (of the total loan amount) and some banks enable the deposit and loan processing fee to be subtracted from the disbursed loan amount. The deposit is most often tied over the loan period and bears no or very negligible interest. Recently, it has been possible to raise a deposit-free housing loan under partially changed loan terms, as banks may require a life insurance policy of the borrower, a larger number of guarantors and/or larger mortgage amount.

2.2. Contract Savings Model – Housing Savings Banks

Croatia, as a number of other countries at the beginning of the transition process, introduced a model to develop housing financing by engaging private citizens' own funds for the purpose of resolving their housing problems. It is a contract model of special-purpose savings with housing savings banks, similar to those in Germany and Austria (Ger. *Bausparkassen*).[14]

To regulate and help develop the contract special-purpose housing savings and financing model, the Housing Saving and Government Incentive to the Housing Saving Act was passed and came into force on 1st January, 1998. It enabled the establishment of financial institutions that specialize in housing financing – housing savings banks. Soon after this Act came into force, housing savings banks began to be founded, expecting a good acceptance in the market and solid business results. Three housing savings banks were founded in the first year after the Act came into force, and one was founded later.

The housing savings banks with the Croatian National Bank licence operating on 30th June, 2004 are:

PBZ STAMBENA ŠTEDIONICA d.d.[15]

PRVA STAMBENA ŠTEDIONICA d.d.

RAIFFEISEN STAMBENA ŠTEDIONICA d.d.

WÜSTENROT STAMBENA ŠTEDIONICA d.d.

The Housing Saving and Government Incentive to the Housing Saving Act defined the terms under which housing savings banks may be established as well as their operations, the housing savings and housing loan terms, the terms, criteria and procedure of using state incentives for housing and penal provisions. Art. 20 Par. 2 Cl. 2 of the Act stipulates that a maximum agreed interest rate to be charged by a housing savings bank on a housing loan may not exceed the interest rate it pays on housing savings deposits by more than 3 percentage points.

Any Croatian citizen, as well as municipalities and towns (provided that they use these funds for the housing construction in order to provide housing to poorer persons) may become depositors and beneficiaries of housing loans by concluding a housing savings contract with one of the existing housing savings banks in the market.

Depending on the length of the saving period, that cannot be shorter than two years, housing savings banks offer various possibilities of saving (e.g. quick, normal and slow; prime, basic and golden etc.) that they call types or tariffs. Payment of housing savings deposits may be agreed on a monthly, quarterly, annual or one-time basis. Complying with the agreed manner of payment by depositors is important because any payment delay or default directly extends the period of saving necessary for raising a loan of the planned amount. Paid-in deposits are guaranteed by the housing savings bank, and they are also subject to mandatory insurance by the State Agency for Deposit Insurance and Bank Rehabilitation.

The stimulation of housing savings by Croatian citizens is visible from direct incentives, i.e. budgetary funds allocated to all the housing savings banks in the amount equal to 25% of one's own payments into housing savings deposits over a previous calendar year. The basis to which 25% in state incentives is added is legally limited to 5,000 kuna (825 USD) at most, so a maximum amount of incentives a single housing depositor may get is 1,250 kuna (206 USD). In view of the interest and state incentives on one's own paid-in deposit, housing savings are exceptionally attractive at the level of individual deposits of 5,000 kuna (825 USD) per person.

Housing savings banks in Croatia operate in accordance with the Banking Law and other regulations of monetary and public authorities that govern the business of banks and savings banks, and their operations are supervised by the Croatian National Bank, the Ministry of Finance and the State Auditor's Office.

An analysis of the operations of housing savings banks in Croatia since they were established reveals two distinct periods: the first did not allow for housing savings contracts with a protective monetary clause (which is often referred to as the "currency clause" in public), and the second period since 8th July, 1999, when agreeing the clause was enabled, making it the main reason for a marked increase in the amount of savings deposited with housing savings banks in the following years. By the end of June, 2004, housing savings banks had concluded more than 560,000 housing savings contracts with private citizens.

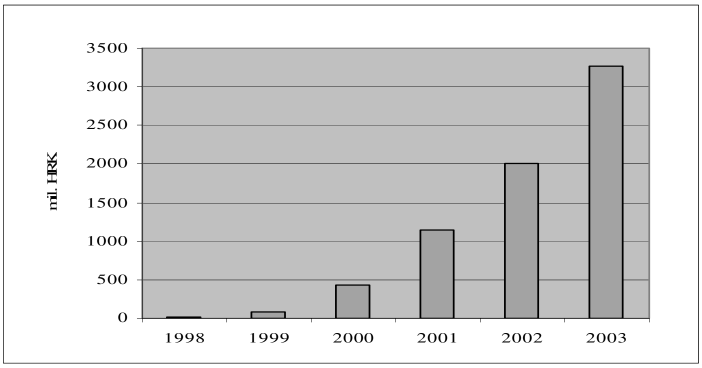
Table 17. Housing Savings Banks' Accounts, in million kuna

ASSETS	1998	1999	2000	2001	2002	2003
1. Reserves with the CNB	2,4	8,6	7,6	15,5	19,1	0,0
2. Claims on central government and funds	49,7	81,4	497,6	1.208,8	1.983,9	3.033,5
3. Claims on other domestic sectors	–	5,3	1,1	11,6	93,3	187,9
o/w: Claims on households	–	–	0,6	11,6	91,3	187,9
4. Claims on banks	54,2	57,0	7,6	18,1	37,2	247,2
5. Claims on other banking institutions	–	–	–	–	–	–
Total (1+2+3+4)	106,3	152,3	513,8	1.254,0	2.133,6	3.468,6
LIABILITIES						
1. Time deposits	8,7	87,6	437,8	1.137,5	2.012,9	3.265,2
2. Bond and money market instruments	0,4	-	10,0	10,0	-	11,1
3. Capital accounts	108,3	117,4	112,5	124,0	141,1	159,7
4. Other items (net)	–11,0	–52,7	–46,5	–17,5	–20,4	32,6
Total (1+2+3+4)	106,3	152,3	513,8	1.254,0	2.133,6	3.468,6

Source: Croatian National Bank

The saving stage begins by concluding a housing savings contract and it lasts until all the criteria on the required amount and saving period have been fulfilled. Afterwards, housing depositors who wish to raise a housing loan enter a loan stage. However, any housing depositors who do not wish to raise housing loans may continue to save and withdraw the funds they paid in, increased by the accrued interest, state incentives, bonus etc.

Figure 2. Total Deposits Collected by Housing Savings Banks



In order to win new depositors, housing savings banks have used the following distribution channels: 1) a network of their external salesmen – organized on various multi-level principles, with all the members motivated to sell by the commission paid on the basis of contracts they conclude with depositors, 2) their own and private licensed sales offices, 3) cooperation with and use of the distribution channels of banks (e.g. their counters and outlets), 4) the Internet etc.

Since the approval of an application for a housing loan is subject to a minimum of two years of purpose savings, housing savings banks only began granting housing loans in 2000, while greater credit activity as far as the number and total amount of approved loans is expected in the future.

Figure 3. Granted Home Loans by Housing Savings Banks, in million kuna

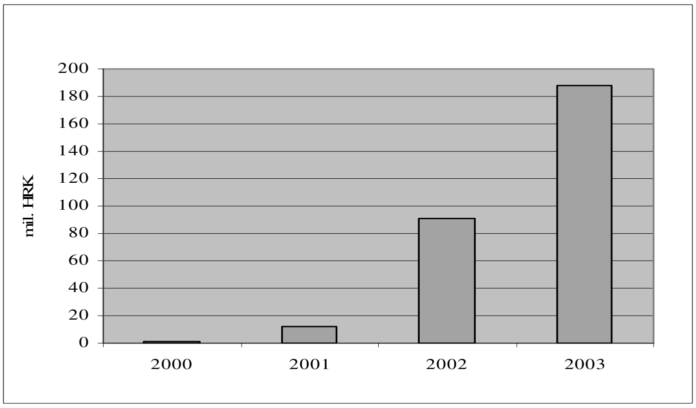


Table 18. Overview of Current Housing Savings Banks Home Loan Terms

HSB:	Interest rates		Repayment period (years)
	Savings	Home loans	
PBZ Stambena Štedionica d.d.	1.50 – 3.33**	4.44 – 5.88**	up to 20
Prva Stambena Štedionica d.d.	3	6	up to 13
Raiffeisen Stambena Štedionica d.d.	3 – 3.5*	6	up to 16 years and 5 months
Wüstenrot Stambena Štedionica d.d.	2 – 3***	5 – 6***	up to 15 years and 8 months

* Higher interest rate (+0.5 %) would be given to the depositors who do not request a home loan after 5 years of saving

** Different level of interest rates is offered depending on the period and type of contract

*** Higher interest rates are calculated for contracts in the national currency

Source: Internet, researched on 11th August 2004

Izvor: Internet, pretraživano 11. kolovoza 2004.

After a housing depositor meets the basic saving criteria (a set period and amount) and applies for a housing loan, the housing savings bank will grant the loan provided that it has assessed the depositor's credit worthiness and the loan purpose positively. Depositors face an almost equal path of gathering various documents for the purpose of proving their credit worthiness to that they would be facing had they applied for a loan at a local commercial bank.[16]

Figure 4. Overview of Deposits and Home Loans in the Housing Savings Banks Model

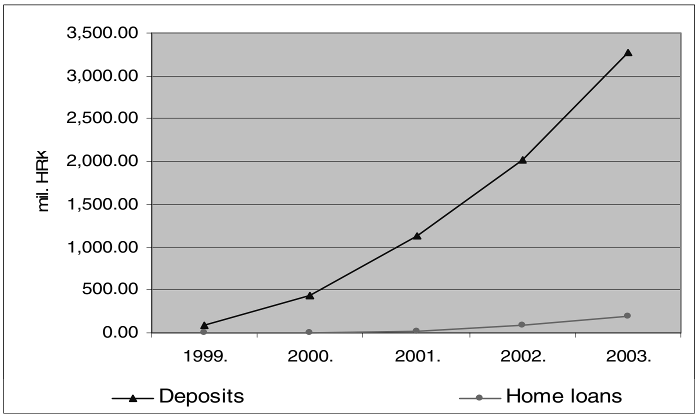


Figure 4 illustrates a rift between the housing savings accumulated by housing savings banks and the amount of housing loans they granted in the period under observation, with their respective trend. Since a significant portion of loans has not yet “come up” for granting, in the circumstances of strong demand for housing loans housing savings banks have been placing the funds for other purposes defined by the law.[17] Under the Housing Saving and Government Incentive to the Housing Saving Act, housing savings banks are not allowed to engage in direct interim financing of housing depositors, but they have all developed a form of cooperation with commercial banks that enables them to offer a product with appropriate characteristics in the local market. Nevertheless, such a form of interim financing has imposed additional costs, while also hampering the development of this product and a whole area of housing savings banks’ business policy. Therefore, instead of financing housing loans their credit potential will be channelled into financing the government and its institutions through bond investment.

2.3. Socially-Supported Government Housing Construction Programme

A socially-supported government housing construction programme (known as “POS”) is the latest market incentive housing model, implemented in Croatia since 11th December, 2001, when the Socially-Supported Housing Construction Act was passed. This model is designed to resolve/improve the housing needs and conditions of households by engaging public funds (those of the government, towns and municipalities) and combining them with the funding of commercial banks and households. It is implemented through the construction of housing units organized so as to optimize the use of public and other funding for the coverage of costs, ensure its repayment and enable the financing of housing purchases on instalment schemes, under more favourable than market conditions as far as the interest rates and years of repayment are concerned. The socially-supported housing construction model envisages the construction of flats provided that their maximum sales price does not exceed 910 euros per sq metre of the net usable area.

Local self-administration units determine the housing needs and interest for the purchase of flats in their respective areas, and are under obligation to provide adequate building site with utilities and other communal infrastructure for this purpose. Those units also set the terms, criteria and procedure for determining the order of priority for the purchase of flats under this model.

If the flats under the POS programme are purchased on an instalment scheme, the buyers have to provide 15 percent of the estimated value of the flat as their own share, 45 percent is financed by a bank loan, while the Ministry of Environmental Protection, Physical Planning and Construction and self-administration units finance the remaining 40% of the value of flats. Each person buying a flat on an instalment scheme has to meet the credit worthiness criteria set by the state Agency for Real Estate Affairs (APN) or a commercial bank providing the loan funds, and the flat being bought is used as collateral to guarantee the repayment of the entire debt including interest. After each such purchase the commercial bank loan is to be repaid first, followed by the remaining part owed to the Ministry and self-administration unit. The annual interest rate charged on the bank portion of the loan is 7.85% and is linked to the six-month EURIBOR, while the interest on the Ministry and self-administration unit’s funding (40% of the flat’s value) is not payable for the first 16 years and only a so-called compound interest at a 2% rate is calculated. Over the next 15 years, the loan is to be repaid at a 5% annual interest, and the total repayment time on an instalment scheme may not exceed 31 year starting from the time a purchase agreement is concluded. The monthly annuity is set as an even amount over the entire loan period, but it may not be smaller than 0.25% of the total purchase price of the flat.

The social dimension of the described model is reflected in the provisions that provide an advantage in the purchase of flats to the households without adequate housing. Under adequate housing we understand flats of 35 sq m in size (with appropriate infrastructure) for a one-member family, plus an additional 10 sq m for each additional member of the household.

By July 2004, a total of 1,521 flats under the POS programme had been completed and delivered to their users, while another 1,834 flats are in various stages of construction. According to the data that has been published, 5,696 flat are currently being planned and the interest in further housing construction has been recorded. The new Croatian government, elected in November 2003, announced further improvements to this model of housing financing.

3. Reguratory Structure

The Banking Law and the CNB regulations form the basis of the regulatory system of housing financing. Since housing financing is an activity that housing savings banks also engage in, it is important to say that they are regulated by a special law that sets a minimum capital requirement of 20 million kuna (3.3 million USD) for their establishment. Housing savings bank operations also have to be in accordance with the Banking Law and the accompanying regulations (much like those of commercial banks).

Table 19. Regulator and Supervisor

	Name of organization	Establishment	Main functions
Primary mortgage market (Lending and credit market)	1. Croatian National Bank	Independent from former Federal National Bank since 1989. Latest law in 2001	Central bank; Supervision Authority for Banks, Housing Savings Banks and Payment System; Banking regulation
	2. Ministry of Finance	-	State Treasury, Supervision, Regulator
	3. Money-Laundering Prevention Office	1997	Anti Money-Laundering Authority - Supervisor for payment transactions
	4.Deposit Insurance and Bank Rehabilitation Agency	1994	Deposits insurance (up to 16,507 USD) and bank rehabilitation
Secondary mortgage market (Funding market)	-	-	-

The business of commercial banks and housing savings banks is supervised by the CNB, along with the Ministry of Finance etc. (e.g. housing saving banks are also supervised by the State Auditor's Office).

Table 20. Main Regulations

	Title of laws / regulations	Enforced date	Main purposes
Primary mortgage market	1. The Banking Law	New one from 2002	Regulates the establishment and operations of Banks and Housing Savings Banks as well as the discontinuation of supervision over bank operation.
	2. Housing Saving and Government Incentive to the Housing Saving Act (HSB Act)	1998	Regulates the establishment and operations of Housing Savings Banks
Secondary mortgage market	-	-	-

Croatian courts have a huge backlog of unresolved cases (estimated at more than one million, 25% of which refer to the issues of collection), and that very often makes court proceedings long and arduous. The record of ownership and mortgage of real estate is kept by land registration units (with municipal courts) that also have a large number of unresolved cases. Making a record of ownership changes takes long (often more than a year); therefore certain properties cannot be put on the market. Still, registering liens upon the order of financial institutions etc. takes precedence so such applications are dealt with more quickly (often within 2 weeks). Property may be pledged by virtue of a mortgage or a fiduciary deed, and the only difference between them is that a fiduciary transfer envisages the property being tied over to the creditor until the debt is repaid and collection by such a creditor in the event of any problems may be easier and relatively quicker (since no court proceeding is necessary to obtain a distress order, as is the case with the other type of pledge). When the value of the pledged property is assessed, it is often estimated to be lower than the real value in order to obtain additional collateral from the borrower and thereby increase chances of collection in the event of forced execution. Also, borrowers are sometimes required, at the time the loans are granted, to agree to a pre-set price that will be asked for the pledged property at a first auction (in the event of loan default), and that later enables an easier sale in order to collect the amount due. In the event that the pledged property is put on sale so as to close a credit position, the costs of execution proceedings are to be settled first, then the interest and finally the principal owed. The debtors in default are liable for penalty interest payment.[18] The process of collection on the basis of pledged property lasts between 3 and 5 years on average. The possibility of pledging movable property to guarantee the repayment of one's financial obligations is regulated by law, but for now there is no single register of pledged property so such pledge notices are published in the official gazette Narodne Novine.

The key national legal regulations that govern housing financing issues are the following: Civil Law, Land Registration Law, Law on Ownership and Other Material Rights, Deed of Assignment Act, Bankruptcy Law, General Tax Law, Income Tax Law, Execution Act, Penalty Interest Rate Act, Draft (Bill of Exchange) Act, Trial Proceedings Act, Notary Public Service Act, Foreign Currency Act and various CNB decisions or directives (e.g. those regulating a single way of expressing the effective credit and deposit interest rate, or a classification of bank credits and potential liabilities etc.).

4. Housing Policy

After World War Two, housing problems were for the most part resolved in two ways: 1) through the construction of family houses funded and built by the owners themselves (so-called self-help) and the purchase of flats from construction companies or housing cooperatives owned by private citizens, and 2) through a distribution of community housing by companies, institutions and other organizations.[19] After former Yugoslavia broke apart, Croatia passed new legislation that regulated housing, thereby initiating a housing reform which is still under way. Consequently, major changes with regard to the housing ownership status occurred between 1990 and 1994 and, in the course of those five years, 57% of the former community (state-owned) flats became private property of households (299,136 community flats, representing 76% of the total, were privatized by the end of 1997)[20]. The privatization of those flats led to numerous doubts and questions concerning their price justifiability (i.e. the issue of whether the prices were realistic) and justification of other terms under which the flats were sold, while there also arose some problems related to the maintenance of housing blocks and their management. The housing reform resulted in the fact that living in one's own flat became a dominant housing status of most households. The so-called «wild» and illegal construction presented an even larger problem related to the land register management and planned housing construction. Hence, the potential for the development of a real estate market trade or mortgage financing of housing construction was limited. Concrete progress in the development of a housing finance system has only emerged since 1997, when the State-Supported Long-Term Housing Financing Fund Act, the Housing Saving and Government Incentive to the Housing Saving Act and a Socially-Supported Government Housing Construction Programme were adopted.

Passing the said legislation marked the beginning of an active housing policy in Croatia that is expected to yield concrete results in several years. So far, commercial banks' credit support to housing financing has intensified and the housing savings project has proven increasingly attractive as the number of newly concluded savings contracts and the accumulated savings continue to grow. The latest government programme, the Programme of Social Incentives to the Housing Construction, has awaken great interest among the population while the state-supported long-term housing financing fund has meanwhile ceased to operate.

Table 21. Government Policy for Own-Housing

Name of the measure	Outline of the measure and recent results	Name of laws	Name of regulator
1. POS model	Dwellings are made available to citizens under favorable price and financing terms. Administrative way of setting the priority for buyers.	POS Act	Ministry of Environmental Protection, Physical Planning and Construction
2. No transaction tax	No transaction tax is charged when a first home is bought	Income Tax Law	Ministry of Finance
3. State premium (direct subsidy)	State premium (direct subsidy) is paid into the Housing Savings Banks system	HSB Act	Ministry of Finance
4. Deductions from the income tax base	Interest paid on home loans (as well as investments into home renovations) are tax deductible from the personal income tax base (up to 1,981 USD).	Income Tax Law	Ministry of Finance

An earlier model (Government-Supported Long-Term Housing Financing Fund), which did not take off in practice, envisaged subsidizing the interest payable on housing loans.[21] However, it is interesting to note that some employers subsidize the interest paid by their employees on home loans, and in turn employees are required to stay with the same employer for a certain number of years. The current government subsidies for housing are reflected in the premium paid annually to depositors under the contract model of housing saving, and the funding allocated under the POS model.

Since 2003, the interest paid on housing loans in the amount of up to 12,000 kuna (1,981 USD) has been recognized as tax deductible in the annual tax returns filed by individual Croatian tax payers. The cost of housing refurbishment/reconstruction of the same amount is tax deductible under the same principle, with tax relief conditional upon living in the housing property financed by the loan.

The citizens buying their first homes (and first-line inheritors) are exempted from the usual transaction tax, imposed at a rate of 5%. When buying new dwellings, the 5% tax is payable on the base that includes the accompanying portion of the land and public utilities services, and is calculated by builders that have to issue appropriate receipts to buyers. Such receipts also have to show the amount of Value Added Tax paid on the material and services built into the dwellings, and buyers (provided that they are part of the VAT payment system) may benefit from the amount of VAT paid. So, when purchasing a new dwelling, parties subject to VAT payment (craftsmen, companies etc.) will fare considerably better (concrete examples known to the Author show that a price reduction by 15-18% is possible).

Table 22. Housing Taxation

SUBJECT	NAME	OUTLINE OF THE TAXATION
Taxation of home-acquisition	Transaction tax	- no charge when first home is bought
		- when new dwelling is bought it is taxed at a rate of 5% on the base that is calculated by a builder (builder issues a receipt). The base for 5% taxation consists of appropriate part of the land and public utilities (municipal services).
	Value-added tax (VAT)	- 22% on the base calculated by a builder could be saved when parties subject to VAT payments are buying new dwellings
Taxation of house-holding	Rents	- when a dwelling is rented the tax base equals the market rent reduced by 30% and than it is to be taxed at a 15% rate (valid for private lessor)
		- in the corporate sector rents are taxed at a 22% VAT rate
Taxation of house-transfer	Transaction tax	- 5% of the value for used dwelling
	Capital gain	- when a second dwelling is sold within three years of the purchase date the capital gain would be taxed as personal income
	Inheritance	- tax free for the closest family (first line), others will be taxed at a 5% rate

The rented housing market is not regulated by the current housing policy measures and that is the area where least work has been done as part of the housing reform. There is no tax relief or anything else that may spur investment into rented housing or its better supply on the market.

5. Concluding Remarks

On the basis of an analysis of the housing financing models presented in this paper one may conclude that Croatia has traditionally been dominated by a deposit-based housing financing model, with commercial banks appearing as the main creditors, although new models and products that have emerged in the past few years are also being developed. As part of the moves to help households resolve their housing problems, the State-Supported Long-Term Housing Financing Fund Act, the Housing Saving and Government Incentive to the Housing Saving Act and a Socially-Supported Housing Construction Programme were adopted. Croatian citizens have shown particular interest in the housing savings bank products and the Socially-Supported Housing Construction Programme, while a state-supported long-term housing financing fund did not take off in practice.

The ratio of housing loans granted by commercial banks and housing savings banks to the Gross Domestic Product has been rising continually over the past few years (it stood at 9.85% at the end of 2003), so it can be expected to continue rising in the future thanks primarily to an increase in the living standards and more accessible financing.

Out of the total outstanding housing loans in Croatia, 98.6% were granted by commercial banks while housing savings banks granted no more than 1.4% of all housing loans. Housing lending is led by the banks with more than 5 billion kuna in assets, and they accounted for 88.65% of the total outstanding housing loans at the end of 2003. Most of the housing loans granted by Croatian commercial banks and housing savings banks are indexed to the euro. Nevertheless, the interest charged by commercial banks is for the most part variable, while housing savings banks grant loans at fixed interest rates.

Whereas bank assurance policies are very frequent and popular instruments of securing regular loan repayment by retail clients in the world, very few insurance companies in Croatia offer or design such products. Nevertheless, it is certain that they will be improved in the future, and the Government might begin by setting the necessary standard and even introduce such instruments through its own institutions.

The operations of housing savings banks in Croatia, as well as those in a number of other countries, depend primarily on state incentives (premium) paid into individual accounts of housing depositors. The Croatian housing savings model could develop further through a process of deregulation of the housing savings bank operations, which would enable interim financing of housing depositors and provision of some other banking services. During such a process, housing savings banks would assume many of the characteristics of banks so it is entirely possible that, some time in the future, they may start operating regardless of the existence or the level of the government premium.

The latest housing financing model (POS) bears a certain resemblance to the social housing programmes in Finland (as households are required to provide 15% of the funding) and France (since part of the responsibility for the programme is shared by the central and local government, with the local government units responsible for the urban and housing planning and preparing the sites for building). Still, the fact that it is heavily subsidized by the government, apart from its "political charge", is a major shortcoming of this model. Its development might be helped by structural changes to enable private sector investment and initiative, thereby reducing state funding for this model.

The rented housing market has not been part of the housing reform to date as far as the supply or the demand side is concerned, so regulating this segment might benefit all stakeholders.

When providing incentives to the housing construction, it would be vital to take note of the volume of construction work and the capacity of local builders, while also improving the accompanying administrative procedures and activities since stimulating measures on the demand side, while supply remains unchanged, are likely to lead to higher housing prices. The data presented here points to an increase in the housing prices, while the construction inputs and other costs have not changed sufficiently to prompt or justify such growth. However, if the purchase of homes is most often financed by the loan products of financial institutions, as is the case in Croatia (often up to 100%), it is right to wonder how realistic those prices truly are, whether a price bubble is being created and what might happen when it bursts. Such an outcome might provoke a financial system crisis, and this should definitely be taken into account when deciding on the housing policy measures.

The problems related to housing financing with the help of the models presented in this paper have not been completely resolved. Therefore it seems justifiable to launch an initiative for designing a national model to envisage resorting to the capital market as a source of funding for housing financing. To that end it is necessary to set the standards or criteria for granting housing loans on the primary market, establish an efficient and comprehensive credit register and a single register of pledged property, while also spurring the development of a system of housing loan repayment insurance (not vital). Certain laws (depending on the model to be developed) would also need to be modified and amended to make sure that the issues such as who may trade in credit portfolios and in what circumstances, are properly and accurately regulated. Licensing and establishment of legal agencies to take part in such a model would also have to be regulated, and Croatia would have to pass legislation governing national mortgage bonds (or mortgage-backed securities), and then set and supervise the minimum criteria that the securities issued on the basis of a mortgage pool have to meet.

Since housing creditors in developed countries are striving to expand their business to foreign markets (through international operations), we may expect them sooner or later to opt for entering the markets of transition countries and, therefore, also the Croatian housing financing market. In that case a wave of refinancing of the existing credit liabilities from more favourable sources may be expected, as well as mergers and acquisitions among national housing creditors. As the process of housing loan refinancing etc. unfolds, we can foresee an increasingly active role of consumer protection institutions.

Resolving the problems of housing financing is a complex task that depends on a number of national specifics so, when determining the national housing strategy measures and policies, conclusions should be made on the basis of the state of the housing sector and the current fiscal policy (particularly as far as tax relief, subsidies, state guarantees etc. are concerned). If Croatia were to embark on reforms so as to reduce budgetary spending on the existing housing financing models (mostly under the POS programme) and design new models (based on market principles), it would be recommended to include international institutions (UN, World Bank, EBRD etc.) in the process.

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APPENDIX: LIST OF BANKS' BASIC INDICATORS AS AT 30 JUNE 2004

No.	Bank name	Total assets (000 HRK)	Share in total assets (%)	Asset growth (%)	Pre-tax income/loss (000 HRK)	Capital adequacy ratio (%)
1.	BANKA BROD d.d.	118,104	0.06	10.93	2,403	39.62
2.	BANKA KOVANICA d.d.	470,954	0.22	17.91	271	17.77
3.	BANKA SONIC d.d.	519,806	0.25	9.42	4,525	15.62
4.	BANKA SPLITSKO-DALMATINSKA d.d.[1]	130,457	0.06	8.58	-1,602	27.20
5.	BRODSKO-POSAVSKA BANKA d.d.	113,857	0.05	-12.22	-14,732	11.91
6.	CENTAR BANKA d.d.	555,927	0.26	1.50	3,001	20.86
7.	CREDO BANKA d.d.	686,976	0.32	5.71	2,958	11.59
8.	CROATIA BANKA d.d.	1,490,012	0.70	2.08	624	16.01
9.	DRESDNER BANK CROATIA d.d.	751,686	0.35	4.08	3,021	35.55
10.	DUBROVAČKA BANKA d.d.	3,106,219	1.46	-6.01	25,659	14.72
11.	ERSTE & STEIERMÄRKISCHE BANK d.d.	20,439,123	9.64	4.72	159,645	15.12
12.	GOSPODARSKO KREDITNA BANKA d.d.	334,794	0.16	9.80	12,634	54.11
13.	HRVATSKA POŠTANSKA BANKA d.d.	5,699,905	2.69	5.20	59,349	26.69
14.	HVB SPLITSKA BANKA d.d.[2]	19,646,792	9.26	3.22	100,680	13.94
15.	HYPO ALPE-ADRIA-BANK d.d.	16,113,271	7.60	14.61	123,207	12.67
16.	IMEX BANKA d.d.	372,911	0.18	-0.20	3,495	21.84
17.	ISTARSKA KREDITNA BANKA UMAG d.d.	1,445,597	0.68	0.48	9,053	16.44
18.	JADRANSKA BANKA d.d.	1,541,661	0.73	-2.69	9,208	17.05
19.	KARLOVAČKA BANKA d.d.	1,126,600	0.53	-2.64	3,951	13.80
20.	KREDITNA BANKA ZAGREB d.d.	765,531	0.36	-0.56	7,302	26.59
21.	KRIŽEVAČKA BANKA d.d.	207,229	0.10	46.38	2,695	19.22
22.	KVARNER BANKA d.d.	243,922	0.12	1.15	3,441	28.95
23.	MEĐIMURSKA BANKA d.d.	1,937,831	0.91	3.44	16,912	15.42
24.	NAVA BANKA d.d.	343,097	0.16	8.93	820	18.67
25.	NOVA BANKA d.d.	5,511,358	2.60	2.14	15,016	13.08
26.	PARTNER BANKA d.d.	705,049	0.33	14.60	10,790	18.95
27.	PODRAVSKA BANKA d.d.	1,388,976	0.65	4.98	5,150	14.63
28.	POŽEŠKA BANKA d.d.	425,861	0.20	-3.50	-974	27.33
29.	PRIMORSKA BANKA d.d.	85,898	0.04	3.52	-690	72.80
30.	PRIMUS BANKA d.d.	248,690	0.12	-14.88	-23,662	10,47 [4]
31.	PRIVREDNA BANKA - LAGUNA BANKA d.d	721,339	0.34	2.82	6,963	23.09
32.	PRIVREDNA BANKA ZAGREB d.d.[3]	38,916,829	18.35	2.98	359,669	13.40
33.	RAIFFEISENBANK AUSTRIA d.d.	21,472,559	10.12	15.41	124,363	12.35
34.	SAMOBORSKA BANKA d.d.	362,233	0.17	-1.42	1,448	33.81
35.	SLATINSKA BANKA d.d.	721,008	0.34	1.71	6,085	22.81
36.	SLAVONSKA BANKA d.d.	4,919,817	2.32	5.81	19,033	28.36
37.	ŠTEDBANKA d.d.	777,439	0.37	-1.38	15,862	38.44
38.	VARAŽDINSKA BANKA d.d.	3,425,072	1.61	-17.13	45,365	16.57
39.	VOLKSBANK d.d.	2,967,278	1.40	10.81	7,705	15.27
40.	ZAGREBAČKA BANKA d.d.	51,288,539	24.18	3.78	644,603	13.18
Total (all banks included)		**212,100,209**	**100.00**	**3.91**	**1,775,245**	**14.92**

Source: Croatian National Bank (Preliminary unaudited data)

Note: Data on the growth in assets are calculated on a year-to-date basis.

[1] Splitsko-dalmatinska banka changed its name into Banka splitsko-dalmatinska on 3 March 2004.

[2] Splitska banka changed its name into HVB Splitska banka on 21 April 2004.

[3] Riadria banka merged with Privredna banka Zagreb on 1 January 2004.

[4] As at 31 March 2004.

NOTES

1 Official gazette Narodne Novine, issue 12/2002

2 According to the Ministry of Environmental Protection, Physical Planning and Construction 2003 Status Report for the Republic of Croatia, 23.7% of the population was young (between 0-19 years of age), mature population (between 20-59 years of age) represented 54.5%, while the old population (60+ years old) accounted for 21.3%.

3 After: Fröhlich, Z., Bežovan, G. and others (2001): Housing Construction – Development Strategy of the Republic of Croatia, pp. 10-13

4 Bežovan, G., Tepuš, M. M., Fröhlich, Z. (2004): «The City of Zagreb Housing Strategy Draft», p. 35.

5 The same ratio at the European Union level totalled approximately 40% at the end of 2003, and was particularly high in Denmark (70%), the Netherlands (more than 60%), as well as in Germany and England (more than 50%).

6 Official gazette Narodne Novine, issue 94/1993

7 Official gazette Narodne Novine, issue 161/1998

8 Official gazette Narodne Novine, issue 84/2002

9 Leko, 1999

10 Banks in the majority foreign ownership had a 91.1% share in total banking assets at the end of the first half of 2004, compared with a 6.7% share at the end of 1998.

11 See: Kraft, Dolenec, Duliba, Faulend, Galac, Šošić and Tepuš, 2001, p.5, almost a half of all commercial banks offered no long-term loans early in 2000. Nowadays, long-term housing loans are available from most banks and the level of interest rate charged makes them most favourable since the country gained independence, i.e. since the beginning of transition.

12 The Croatian National Bank has set the effective interest rate, i.e. the unique method of calculation of interest rates that the banks have to present to clients and public, since 1st January, 2002.

13 The mortgaged property has to be insured against fire, natural disasters etc. in the minimum amount equal to the loan amount (hazard insurance).

14 The first housing savings banks in the transition countries of the region were founded in: Slovakia in 1992, Czech Republic in 1992 and Hungary in 1997.

15 PBZ Stambena Štedionica d.d. began operating early in 2003. At the time Hrvatska Stambena Štedionica d.d. ceased to operate as its entire portfolio was taken over by Prva Stambena Štedionica d.d., Zagreb.

16 For further material on the operations of housing savings banks in Croatia see Tepuš, 2002.

17 The lending policy of housing savings banks is regulated by Art. 10 of the Housing Saving and Government Incentive to the Housing Saving Act, which stipulates that the funds may be used for financing clients' housing loans, investment into the financial market instruments with first-class guarantees (deposits), as well as for the purchase of first-class sovereign securities issues and other securities issued with state guarantees or bank guarantees and placements with safe credit institutions.

18 The level of penalty interest is set by the Croatian Government, it currently stands at 15%.

19 Jelinić, 1994

20 Bežovan, 1998

21 For further material on the Government-Supported Long-Term Housing Financing Fund see: Tepuš (2004)

CHAPTER 10. HOUSING FINANCE IN ROMANIA

by
Diana Popescu[1]
Ion Bejan[2]
Mihaela Kalogerakos[3]

1. Macroeconomic Characteristics

Economic re-launching started in 2000 has continued at a sustained rhythm based on domestic demand acceleration. In 2001–2004, Romania registered an effective and relevant correlation between the strong economic growth, on one hand, and disinflation and maintaining internal and external deficits in sustainable limits, on the other hand. The cumulative GDP has risen by more than 25% between 2001-2004, as a result of a real cumulative rising by 26% of the final consumption and by 45% of the forming rough fixed capital. The inflation rate was diminishing from over 40% in 2000 to only 9.3% in 2004. Romania reached in the previous year the lowest level of inflation recorded in the transition period while the economy grew by a real percent of 8.3%. It must be mentioned that the current account deficit faced an important deterioration from 6.0% of GDP in 2003 to an estimated level of 7.6% of GDP in 2004. The non-Governmental lending recorded an important growth by 38% (26.3% - in real terms) in 2004 compared with 2003, following a real growth of 50% recorded in 2003. Taking into account the E.U. accession in 2007, we anticipate that on medium term the Romanian economy will continue this way and that the GDP will rise (as yearly average) with 6% during 2005-2008.

Table 1: Main macroeconomic indicators

Indicator	Unit	2001A	2002A	2003A	2004F	2005F	2006F
Nominal GDP	US$ ban	40.2	45.8	57.0	71.7	104.3	129.0
GDP growth (real)	%yoy	5.7	5.1	5.2	8.3	6.0	5.3
Industrial production	%yoy	8.5	6.0	3.4	4.3*	7.0	7.0
Inflation rate	%yoy	30.3	17.8	14.1	9.3	7.0 t	5.0
Net monthly income	Average EUR	116	121.2	128.8	147.17		
Current account balance	% of GDP	5.5	- 3.3	- 6.0	- 7.6		
Exchange rate	EUR avg.	26,026	31,255	37,556	40,532*	35,734	34,662
Fiscal balance (%GDP)	% GDP	-3.3	-3.1	-1.5	-1.6	-1.5	-1.4
Total public debt	% GDP	28.7	28.8	26.8	23.5	21.8	20.5
Gross domestic savings	%GDP	14.9	17.9	16.8	16.9	18.4	19.9

*actual figures, t: target   Source: NBR, MoF, NISES, ABN AMRO forecast

2. Supply and Demand of Housing

According to the latest census of houses and population (2002), in Romania there are 8,107,114 dwellings located in 4,848,100 residential buildings, most of them (52.5%) being situated in urban

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[2] Senior advisor, Ministry of Transport, Construction and Tourism
[3] Superior inspector of the General Department of Housing Construction, Ministry of Transport, Construction and Tourism

areas. The essential characteristic of dwelling in Romania is represented by the ownership structure: almost 97.5% of existing housing stock is privately-owned, a fact that strongly limits labour mobility.

Romania is a country with a population of 21,680,974 inhabitants (the ninth place in Europe), out of which 52.7% live in urban area, 51.3% are female and the average age, which is on rise, is 37.3 years. Being a country with the biggest housing stock in South Eastern Europe, Romania has a number of 348 dwellings per 1000 inhabitants, bigger than the average of the region (304), but smaller than the EU average (490).

Considering the size of living area, it can be noticed that this is smaller than anywhere else in Europe: 14.4 sq m/person. This issue of "overcrowding" can only be solved by new residential construction. The rate of renewal of the housing stock has drastically decreased after 1990 and the private sector was unable to compensate for the diminution of the public funds allocated to housing construction.

The annual renewal rate of housing stock is still reduced: less than 30.000 new housing units yearly, which represent about 0.35% from the existing housing stock. About 80% from those new housing units are financed from private funds, in most of the cases without choosing a long term mortgage loan.

The decrease of the number of inhabitants and the ageing society should reduce the housing demand, but the increased number of homeowners and the small living area per person maintains a significant demand for new dwellings.

According to some estimation, almost 9% from the Romanian citizens strongly need a new house, and 13% have a potential need. Therefore approx. 200,000 of the Romanian households represent the effective request for houses.

Prices and affordability

Preferences go for single-family houses (whose prices are almost equal to that of a centrally located apartment). Increase in demand for land and scarcity of it in urban areas pushed up prices. It is common to hoard up agricultural land for a few cents/sqm, gaining urban status for it and selling it. A speculative land market is developing also in relation to shopping malls building and major infrastructure construction.

Presently housing is affordable for families with an annual income over 150,000 Euro.

3. Housing Finance Market and System

Primary mortgage Market

The Romanian mortgage market had an explosive evolution over the last two years. At the end of 2002, the volume of the residential mortgage loans amounted to approximately 200 million USD, which was less than 0.5% of GDP. In 2003, this level doubled to approximately USD 1.1 billion (end of 2004), representing more than 1.5% of GDP The National Bank of Romania - will still maintain this rate of increase in spite of the introduction of some restrictive lending conditions at the beginning of the previous year. Most of the mortgage loans are provided in foreign currency (with interest rates ranging from 8% to 12%), only 13% from the loan portfolio being in the local currency – ROL – due to still high interests rates (14% to 18%). If three years ago the National Housing Agency was the only institution providing mortgage loans for a period of up to 25 years, now there are more than 15 commercial banks, 2 mortgage loan companies and a "Bauspar" bank which compete on the increasingly attractive mortgage market as a result of the continuous improvement of the macro-economic conditions (annual average increase of GDP by 5%, reaching 8.3% at the end of 2004), constant decrease in inflation (a 9,3% inflation at the end of 2004), increase in investments and consumption.

Percentage changes as compared to the corresponding period of the previous year

	MU	2002	2003	2004
Final consumption	%	+4.9	+6.9	+9.4

Secondary Mortgage Market

For the time being the Romanian financial institutions fund their mortgage loan activity using their own resources, short term deposits and financial facilities specially provided by international financial institutions (EBRD, IFC, DEG), so that the Romanian mortgage market lacks adequate financing/refinancing alternatives. Taking into account the necessity to diversify the existing financing sources, the new legal framework necessary for the creation and development of the secondary mortgage market - which contains the Mortgage Banks Law, the Mortgage Bonds Law and the Securitization of Receivables Law - has been recently finalised. It is expected that it will soon be approved. Building a sustainable secondary mortgage market with viable refinancing instruments, will address the risks faced by lenders.

4. Housing Policy

4.1. Government Policy for Own-Housing

New housing production still has not returned to pre-transition levels and the shortage of housing constraints labour mobility, which in turn contributes to the unemployment problem. High interest rates create affordability problems in home mortgages that are a real constraint, but effective demand for mortgages is far below potential demand.

Although much progress has been made, there are many challenges that lie ahead. There are three major issues for the immediate future:

- The poor condition of the existing housing stock;
- The persistent housing shortages;
- The use and affordability of home mortgage products

The main housing policy objectives of local government housing policies:

- First and the most important: support for new rental housing construction designed for low income households and another disadvantages groups of households
- Second objective: support for rental housing construction designed for young people and specialists in partnership with NHA through government housing program
- Improvement of technical infrastructure quality of the existing social housing stock

Subsidies for targeted social groups: up to 30% from the construction cost, according to the Government Ordinance no. 19/1998, for the completion of the unfinished residential units situated in multileveled residential buildings

A 20% subsidy from the construction cost of the houses purchased from the NHA offer: Law no 152/1998: under the process of amendment

Subsidies and state support for the existing housing stock

Retrofitting of the multileveled housing buildings ranked in the 1st seismic risk class:

- From the budget of MTCT: design and execution of the consolidation works
- Reimbursement in 25 years, equal monthly rates, nil interest rate
- Exemption from the payment of monthly rates for persons with monthly incomes per family member below the average net monthly income per economy (In 2004 – G.O. no. 643/2004, which provides the rehabilitation of 36 buildings in different stages – design, execution – in Bucharest, Roman, Suceava, Bacău, Brăila, Galați)
- Law no.460/2001, Governmental Ordinance no. 20/1994 with later modifications and completions; Support through annual Governmental Decision

Thermal rehabilitation of the multileveled housing buildings for the reduction of energy loss:

- From the budget of MTCT: expertise and energetic audit, design
- Execution of rehabilitation works: 25% subsidy from the state budget, 15% from the homeowners' associations repairing fonds, 60% credits (5% interest rate per year, reimbursement in 10 years)
- Tax exemption for the delivery of the energetic certificate and the construction license
- Tax exemption on dwelling for the whole credit reimbursement period

The project was conceived in 3 stages:

- STAGE I (2003-2004): Pilot programme (in 12 counties) - completed with financial support from the Swiss Counterpart Fund; Target - multileveled-housing buildings in public property
- STAGE II (2004-2005): Target - multileveled-housing buildings in public property
- STAGE III: generalization of the programme; Target - multileveled-housing buildings in private property

Besides, another pilot project for two other buildings in public property in Piatra Neamt, fully supported from the MTCT budget, was initiated.

- Governmental Ordinance no.29/2000 (approved through Law no.325/ 2002); Emergency Governmental Ordinance no.174/2002 (approved through Law no. 211/2003); Methodological Norms for applying the Emergency Governmental Ordinance no. 174/2002, approved through the Governmental Decision no.1070/2003; Normative-technical framework for technical regulations in the field of energetic expertise and audit of the existent buildings

4.2. Government Policy for Rental-Housing

- Housing Law no 114/19961 to assure the access to a decent house for the individuals with low incomes:

- Law no. 152/1998 to assure the access to housing for young people under 35

This public housing stock is administered by local authorities, which approve the rent level.

4.3. Housing Taxation

- Property tax for individuals: 0.2% for houses in urban areas; 0.1% for houses in rural areas; for more houses in ownership the property tax is increasing gradually

- Property tax for legal persons: 0.5% - 1% from the book value depending on Local Council decision

- Stamp duty: As a rule this tax is paid by the buyer, even there is no legal regulation

- Value-added tax for companies: the legal persons must collect VAT

- Tax on profit for companies: 25%

- Tax on profit for micro-enterprises: 1.5%

These figures are for the end of 2004, a new tax code is effective as of January 1, 2005.

4.4. Urban Development, Land and Other Policies

Spatial settlement development

- Regulation of spatial settlement development with specific provisions for each urban function and activity, including housing, in relation with the territorial development of the counties and the National Territorial Development Plan (including the Section I regarding the national transportation networks – Law no.71/1996, revised and submitted for approval, Section III regarding the protected areas – Law no.5/2000 and Section IV regarding the settlements network – Law no.351/2001)

- General information regarding the housing structure at national level as a basis for the foundation of the housing policies

Twenty three out of forty one counties have County Territorial Planning Plans, while other 4 are in process of approval and 4 are in process of revision and updating. Regulations had been elaborated concerning each of the approved Sections of the National Territorial Development Plan since 2001 been completed 6 regulations regarding Section I, 7 regarding Section III, 7 regarding Section IV. 98 other regulations concern the urban and territorial planning activity.

Town planning control

- Town planning activity regulated by the Law on territorial and urban planning – Law no. 350/2001.100% of cities and towns and 99.01% of the communes have general urban plans and urban regulations approved. Updating process started with priority on Pan-European road corridors implementation. During the last 4 years 532 urban documentations had been advised by MTCT concerning the inner city developments, revitalization of historical centers, new housing developments, etc., while the approval is decided at local level, according to the law.

Protection of natural risk areas

- Specific regulations for the development of the natural and built areas exposed to natural risks (earthquakes, floods) with impact on the development of residential areas within the human settlements – Section II regarding the water ways (Law no.171/1997) and Section V regarding the natural risk areas (Law no.575/2001)

Regulation of urban planners' professional status: Law regarding the Urban Planners Order

Four regulations regarding Section V of the National Territorial Development Plan had been completed and approved. Action initiated to transpose in the regulations of the General Urban Plans of the administrative units the regulations regarding the protected risk areas.

CHAPTER 11. HOUSING FINANCE IN UKRAINE

by

Oleksiy Pylypets, Pavlo Matiyash*

1. Supply and Demand of Housing

Providing with housing in Ukraine is inadequate. One third of Ukrainians live in unsatisfactory conditions i.e. have less than 9 m^2 of the floor area per person. Around two million households or six millions individual are registered on waiting lists for improving housing conditions. On average, a Ukrainian resides on 20 m^2 which is two to three times as little as in developed countries.

After long recession in the housing construction industry, it saw gradual revival in 2001 through 2003. For instance, in 2003 developers of all ownership forms put in operation 62,300 apartments totaling 6,433,000 m^2 that is 15,7% more as compared to the year of 2000. The growth is secured mainly due to increase in construction by private construction companies. In 2003 they placed into operation 61,4 % of all newly constructed dwelling units (59% in 2001 and 60% in 2002). It is important to emphasize that in 2003 the construction industry had the highest growth rate (23 %) and outpaced the GDP growth rate considerably. A similar situation was in the first quarter of 2004.

Nevertheless, the housing problem in Ukraine still remains unsolved (like it was under the Soviet time) even though construction of new high quality housing and improvement of existing residential buildings (through overhaul) enhanced the quality of available housing, primarily, in cities.

It is worth noting that people rarely seek free state housing because of long waiting lists and little volume of state housing construction. Therefore, households will be trying to solve the housing problem with their own funds.

Proper maintenance and preservation of the existing housing stock is another important solution of the housing problem. In particular, this relates to residential areas developed between 1946 and 1970.

As overhaul of dwelling units is funded from the state budget, budget constraints lead to shrinking of housing repair program, overall deterioration, accelerated depreciation, and decommissioning of the housing stock. According to the official statistics, 4,800,000 m^2 of housing was in the emergency condition as of 2003.

2. Housing Finance Market and System

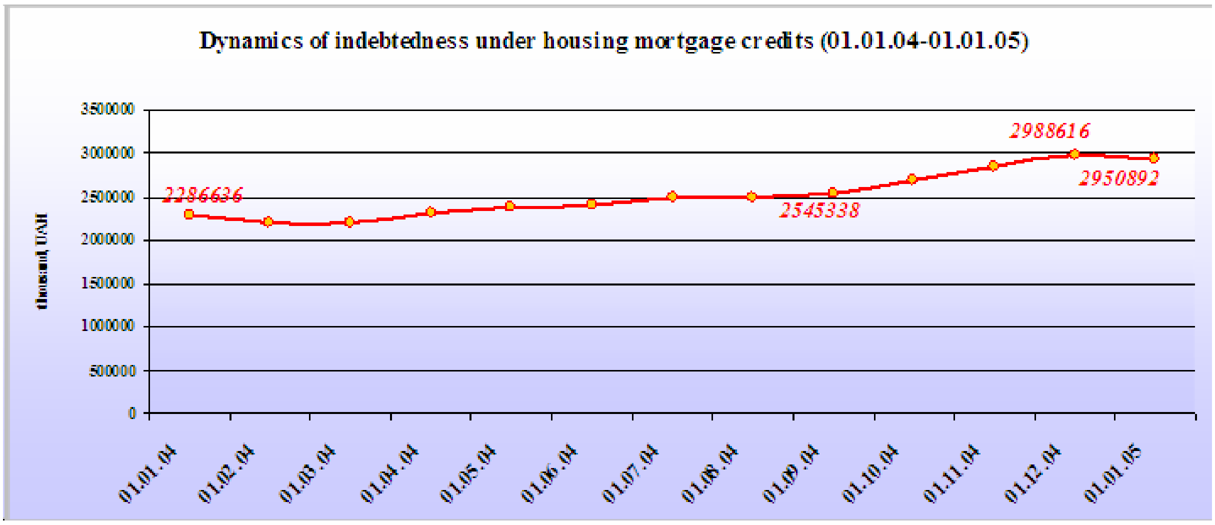
Primary Mortgage Market

As of April 1, 2004 the total amount of loans secured by mortgage or given for the purpose of funding construction was UAH 5,129,000 i.e. it had grown 3.6 times or by UAHD 3,694,000 from early 2002. As of April 1, 2004 the total debt to banks under credits given to individuals for housing purchase and

* Specialists on Mortgage of Ukrainian National Mortgage Association

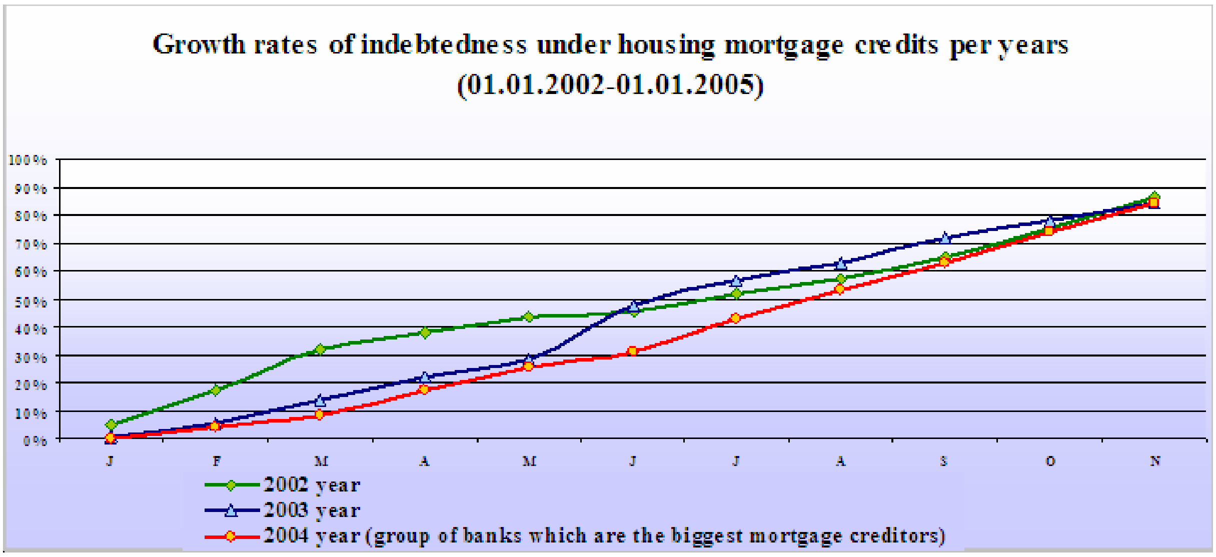
financing of housing construction was UAH 1,462,000 whereas that of legal entities was UAH 3,668,000.

As of 01.01.05 the total indebtedness under housing mortgage credits or given for housing construction financing totaled 2951 millions UAH that is, increased 9,3 times or 2633 millions UAH from the beginning of 2002.

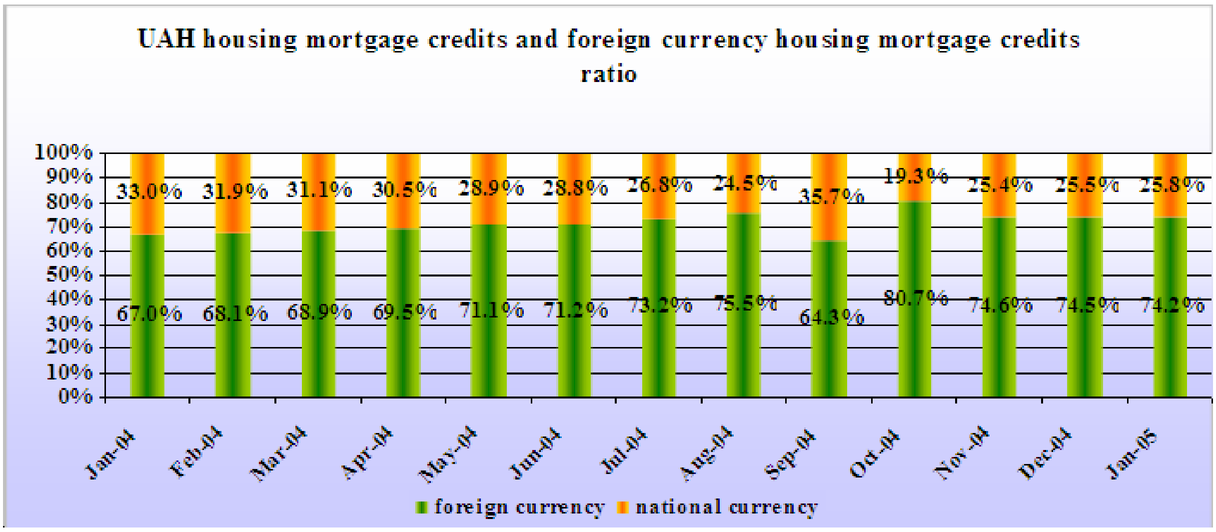


On the whole, the total of outstanding mortgage loans was increased by 257.4% between January 2002 and March 2004 or, in other words, it grew by 5.2% each month.

As a whole, for the period from 01.01.2002 to 01.01.2005 the volume of indebtedness under housing mortgage credits has been increasing on average 4,7% per month. It's important to emphasize the relative stability of dynamics of increase of indebtedness under housing mortgage credits for last three years.

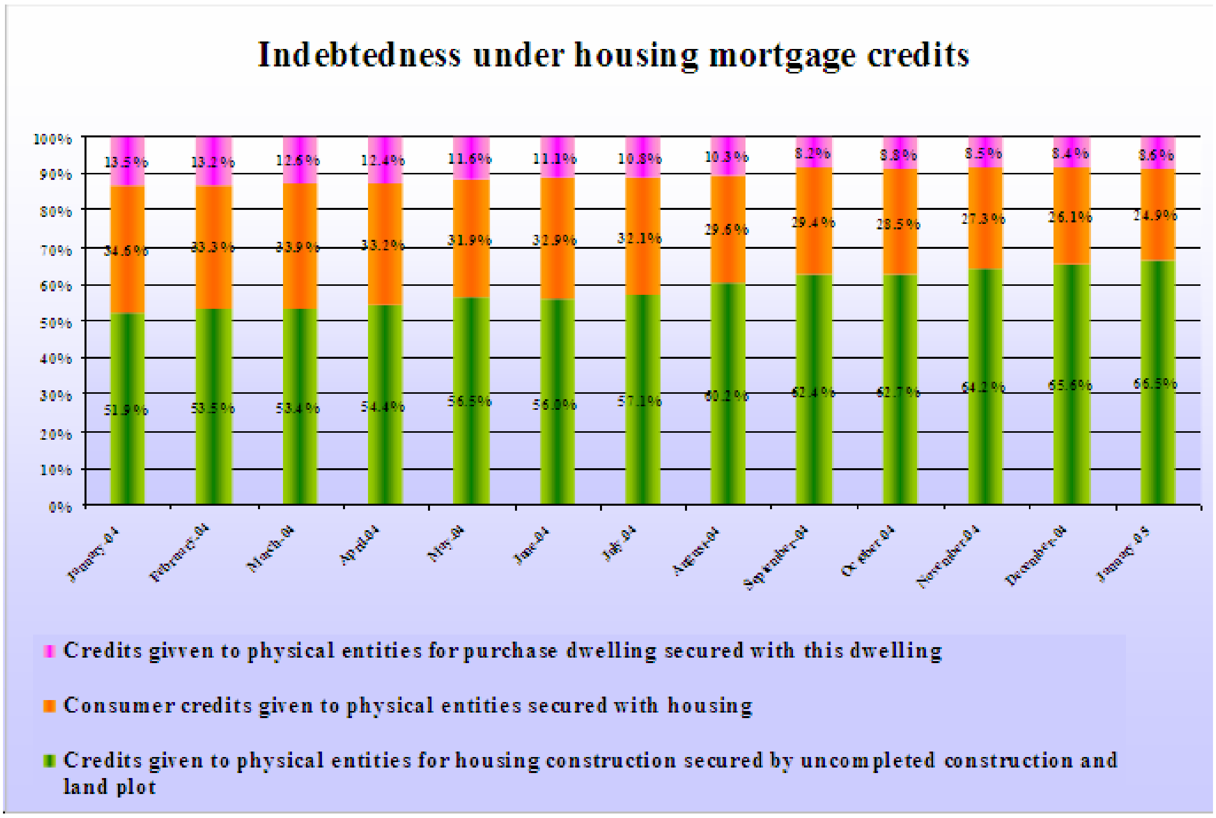


It is necessary to emphasize the considerable difference between volumes of crediting in national and foreign currencies. It is explained by the fact that in the secondary market payments are made in foreign currencies and by existence of a large grey sector of the Ukrainian economy and relatively high unofficial individual income, accordingly.

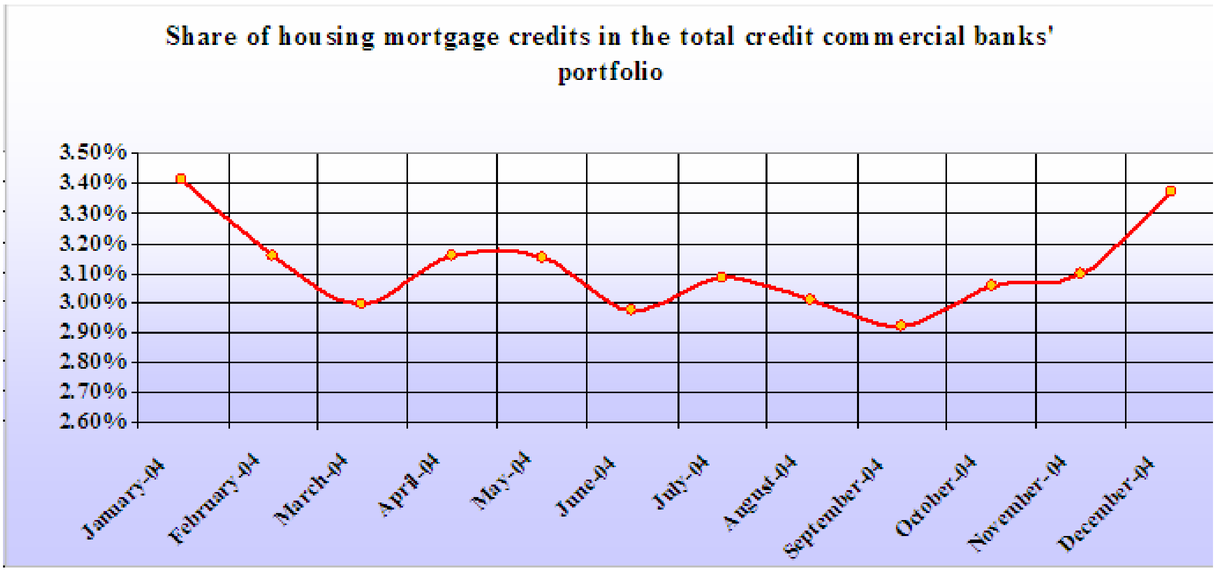


Undoubtedly, growth of mortgage lending in the national currency is hampered by lack of such risk management tools as, say, a variable interest rate, which is caused by insufficient objectivity (unreliable projections) of those measures which could be used as indicators to adjust the interest rate to.

To the large extent, corporate relationships between come commercial banks and housing construction companies speed up growth of mortgage lending. That is, bank-controlled lending of housing construction as a source of funding at early stages evolves into lending of direct investors with the secured right of claim under investment contacts, which are secured by housing mortgage at the completion of construction.



Growth of housing mortgage lending and lending for housing construction purposes slowed down in early 2004 for a number of reasons directly affecting the lending market and demand for housing mortgage loans in particular.



The first and foremost factor is probably expectation on the part of potential borrowers that prices for housing will grow at a slower pace if not go down. That is what actually happened: the growth did slow down; the prices were not decreased though. Prices for newly constructed housing became even higher because VAT concessions were eliminated for buyers at the primary real estate market.

The market reacted to the rapid growth of prices for property in the summer of 2003, which exceeded the projected growth, with falling volume of loans.

The prices for property began skyrocketing in the fall of 2001; sometimes the prices went up by 25% over a quarter. As early as in the fall of 2002 they exceeded the level before the 1998 financial crisis.

Since the Kyiv real estate market (both primary and secondary) is the largest in Ukraine, this report is based on information on price patterns at this particular market. For example, the Kyiv market accounted for 75% of the total Ukrainian market in 2003.

According to experts, prices for housing grew by 25% to 30% over 2003 on average. Therefore, prices for apartments in Kyiv were increased 2.5 times since early 2001. Unlike previous years, when small and cheap dwelling units saw the most rapid growth, in 2003 it was characteristic of high quality one and two room apartments. In some market segments, the growth reached 60 percent.

Another reason is legislative. Namely, despite the Law "On Mortgage" was enacted effective the beginning of this year, there was no law which would regulate ownership of real estate property. That is why banks found themselves in a rather risky situation and reacted accordingly.

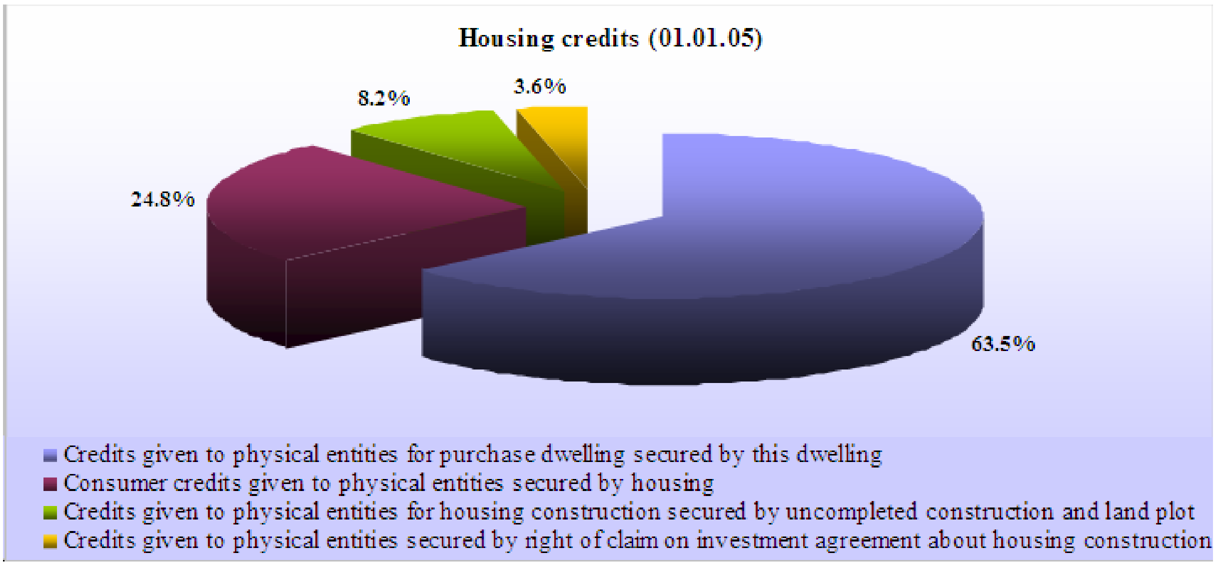
Some banks raised interest rates on mortgage loans in foreign currencies up to 17% to 18% although in some cases this increase in interest rates was caused by insufficient liquidity (lack of credit resources with creditor banks).

The situation improved significantly after the Cabinet of Ministers approved a temporary procedure for state registration of mortgages.

Secondary Mortgage Market

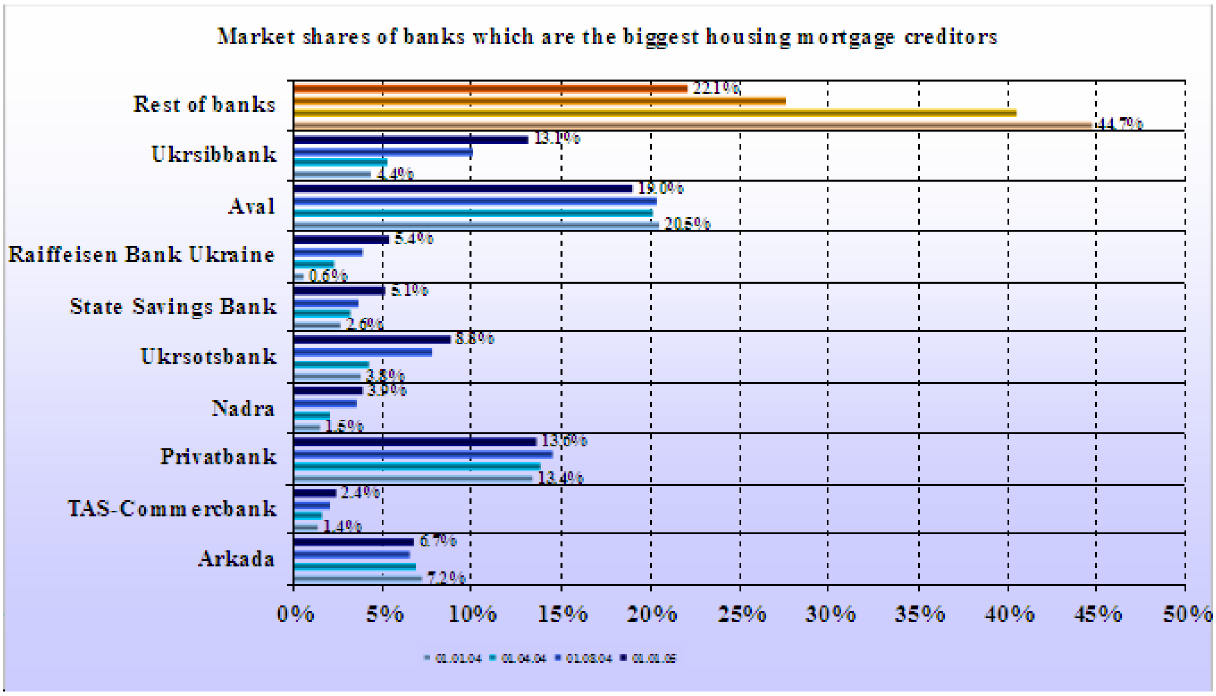
Until recently, mortgage loans were regulated by the Law "On Pledge" dated 1992. In June 2003 the Parliament of Ukraine (Supreme Rada) passed the law "On Mortgage ". This law defines basic terms, first of all the mortgage, establishes requirements to the subject mortgage and its insurance, defines obligatory parts of the mortgage contract, clarifies rules for selling real estate. Besides, the Law defines a collateral note, an instrument used to secure a mortgage loan contract. Mortgage of agriculture land will be launched in 2005. The mortgage lending market is also regulated by such laws as "On Mortgage Lending, Transactions with Consolidated Mortgage Debt, and Mortgage Securities", "On Financial-and-Lending Mechanisms and Property Administration in the Process of Housing Construction and Transactions with Real Estate", "On Securities and Stock Exchange".

Loans account for roughly 45 percent of all transactions in the banking sector in terms of asset value (corporate loans – 84 percent, loans to individuals – 16 percent as of 2003). As far as loans to individuals are concerned, most are consumer credits while housing mortgage loans account only 20 percent to 30 percent.



During the last two years, some banks were particularly active and gained large parts of the Ukrainian mortgage lending market. These are Savings Bank, Ukreksimbank , Nadra, Arcada, Praveksbank, Aval, Promivestbank , Privatbank, Ukrsotsbank, Ukrsibank, Brokbiznesbank. They have nationwide network of branches and offices and compete with each other at housing mortgage lending market in large regional centers. Eleven major operators of the housing mortgage lending market accounted for 69.7 percent of the market in early 2002, 67.9 percent in early 2003, and 69.7 percent six months later.

Two more banks – Brokbiznesbank and Ukrsibank – joined the group of eleven major banks (those with more than 1% market share) in 2002. They covered 5.4 percent and 4.1 percent of the market, respectively. Therefore, the group of 13 major players took up 78 percent of the market in 2004.



The market shares of the major players (banks) at the housing mortgage lending market remained practically unchanged during the period under review. Despite the total value of each bank' loans was increased, their market shares changed insignificantly.

3. Regulatory Framework

The Government is interested in developing the mortgage system as an institute and supports operation of the mortgage lending market in Ukraine by passing enabling legislation.

Selected laws regulating the Ukrainian mortgage lending system are listed below:

- Civil Code of Ukraine
- Commercial Code of Ukraine.
- Law of Ukraine "On State Registration of Titles to Real Estate";
- Law of Ukraine "On Mortgage";
- Law of Ukraine "On Financial-and-Lending Mechanisms and Property Administration in the Process of Housing Construction";
- Law of Ukraine "On Mortgage Lending";
- Law of Ukraine "On State Statistics";
- Law of Ukraine "On Amending Selected Laws of Ukraine".

The full list of the enabling legislation is posted on:

http://unia.com.ua/Portal/portal/alias __ unia/lang __ en-US/tabID __ 3349/DesktopDefault.aspx

Major regulations in the area of mortgage technologies include:

- Procedure for partial reimbursement of the interest on commercial banks' loans;
- Concept for creating the national system of mortgage finance;

On the whole, technologies incorporated in the current legislative and regulatory frameworks are sufficient for operation of the mortgage lending system in Ukraine. However, new laws will be needed to ensure further development of mortgage relationship. The Association is actively involved in the process of drafting these laws.

The Association initiates drafting of many laws intended to modernize existing mortgage lending technologies in Ukraine. Many of these draft laws have been already registered in the Parliament and decisions on them will be made soon. These are:

- Draft Law "On Mortgage Securities"
- Draft Law "On State Land bank"

- Draft Law “On Trust Management of Property"
- Draft Law "On Mortgage Institutions"
- Draft Law "On Land Market"
- Draft Law “On Financial-and-Lending Mechanisms of Housing Construction"

At the moment, mortgage loans account for 0.7 percent of all loans in Ukraine. Despite rapid growth of this percentage, the share of mortgage loans is still too small to include complex mortgage lending schemes or the illegal schemes you mentioned. All mortgage contracts in Ukraine are executed as loan contracts together with a pledge contract i.e. borrowers pledge ownership of property. These are primarily commercial banks’ loans for purchase of real estate property on the security of this property. The refinancing system is at the development stage and, thus, not operable in Ukraine. The Government of Ukraine is in the process of developing an operation system for the 2nd level mortgage institution and cooperates closely with our Association in this matter.

The Ukrainian mortgage lending market is regulated by laws shown in the table below. Most of them were passed last year which suggests rapid growth of this market.

Main Regulations	Enforced Date
1.The law “On mortgage”	05.06.2003
2. The law “On mortgage lending operation with mortgage funding and mortgage certification”	19.06.2003
3. Civil Code of Ukraine	16.03.2003
4. The law “ On securities and stock exchange”	18.06.1991

4. Housing Policy

Privatization of housing in Ukraine began in 1992. By now, more than a half of the housing stock has been privatized. With allowance for private housing and construction cooperatives, individuals own some 80 percent of the Ukrainian housing stock today.

By allowing individuals to own housing, the Government revises the fundamentals of its housing policy. The Parliament adopted the Concept of the State Housing Policy on June 30, 1995 which envisaged:

- To enable individuals to buy or construct housing according to their needs easily;
- To provide housing to vulnerable categories;
- To give loans for purchase or construction of housing to households on housing waiting lists and to young families;
- To encourage state housing construction;
- To develop construction of more comfortable housing;
- To provide separate housing units to residents of communal apartments; to move out households residing in apartments built under Khrushchov;

- To create and develop the housing and utility sector in rural areas;
- To bring the housing sector up to the 100% cost recovery level on a phased basis;
- To redistribute responsibilities among government authorities, local governments, and organizations/companies involved in housing construction, renovation, and maintenance with a view of decentralization as economic reforms go

The "Concept" accentuates that one of the major factors necessitating the reform of the housing and utilities sector is "an excessive monopolization of construction, reconstruction and habitation maintenance", and the main ways of realization of the state housing policy are "continuation of privatization of the state available housing, creation of the housing market and market structures in housing sector ".

Such way has been described in "the Concept of the state housing policy in which "the obligatory unification of owners of apartments in apartment houses in societies is proposed with the purpose of securing appropriate maintenance of houses and adjacent territories.

In order to speed up local decision-making processes on establishment of societies and regulation of their activities, by Resolution of the Cabinet of Ministers of Ukraine № 588 as of 31.07.1995 has been approved the Provision on establishment and activity of societies of co-owners of apartment houses. For performance of this Resolution, the Derzhzhytlokomungosp (the State Housing and Utilities Facilities) of Ukraine in April, 1996 has developed and approved the “Typical statute of societies” and "Provision on the procedure of their state registration ". At the same time, the State Committee on land, the State Committee on town-planning and architecture, the State Committee on housing and utilities services and the State Property Fund approved " the Provision on establishment and fixing borders of territories adjacent to the houses ", their granting as the common property or for the common use to societies of co-owners of housing apartment houses.

The law of Ukraine " On re-structuring of arrears of wages , payments for the housing and utilities services, consumed gas and electric power " as of February, 20, 2003 № 554- IV has established as of July, 1, 2003 the mechanism of re-structuring of debts during the period within 60 months by conclusion the contract with the public utilities supplier. In this contract the amount of monthly payments of the debt sum is mentioned, taking into account, that together with the current payments, it should not exceed 25 % of the income of a citizen which has concluded the contract.

To perform Decree of the President of Ukraine № 1165 of December, 4, 1996 " On additional measures concerning realization of the state youth policy " the State Fund for the Assistance to the Youth House- Building was created that is the state specialized financial institution, subordinated to the Cabinet of Ministers of Ukraine which acts on the basis of the Provision approved by the decision of the Cabinet of Ministers of Ukraine № 1604 as of October, 26, 2000.

At the present, the Fund carries out such kinds of activity:

- according to the resolution of the Cabinet of Ministers of Ukraine № 584 of May, 29, 2001 " On the procedure of granting lax long-term credits to young families and lonely young citizens for construction (reconstruction) of habitation" gives long-term credits for construction and purchase habitation by young families, the age of husband and wife makes till 30 years inclusive, and also to lonely young citizens till 28 years inclusive. The maturity of credit – to 30 years.

- according to the resolution of the Cabinet of Ministers of Ukraine № 853 of June, 4, 2003 " On approving the procedure for partial reimbursement of interest on commercial banks loans to young families and lonely young citizens for construction (reconstruction) and purchase of habitation " the partial reimbursement of interest on commercial banks loans is given to young families and lonely young citizens for construction (reconstruction) and purchase of habitation. According to this resolution the borrower receives reimbursement to the sum of discount rate of the National Bank of Ukraine.

The Fund is a responsible executor of the State Program on providing youth with habitation for 2002 - 2012, that is approved by the resolution of the Cabinet of Ministers of Ukraine №1089 of July, 29, 2002. The present Program allows not only to solve housing problems, but also assists to improvement of the demographic situation in the country.

The Government of Ukraine pays a significant attention to the development of the youth housing construction. 65.5 millions uah from the State budget of Ukraine were allocated for the State program on provision youth with habitation in 2005. According to results of the year the Fund was financed in full. Besides, for the first time, according to the Fund's proposal, the basic volumes of financing of the Program in 2005 were envisaged for the spring-and-summer period - optimum for building.

It's worth noting, that according to results of 2002, the Fund and its regional branches were financed in volume of 50.1 millions uah from the state budget funds, that makes 65.1 % from the annual purposes, envisaged for Fund by the Law of Ukraine " On the State budget for 2002". For 2004 the Government action plan envisages to triple a number of credits for construction and habitation purchase for youth, countryside inclusive.

For 2004 the State budget of Ukraine envisaged for youth housing crediting:

- 100 millions UAH from the general fund of the State budget

- 6.7 millions uah. From the special fund of the State budget (funds received from old loans repayment)

The Law of Ukraine " On amending the Law of Ukraine " On the State budget of Ukraine for 2004 " № 1801-IV of June, 18, 2004, envisages for the Fund increasing of funds for the youth housing crediting up to 130 millions uah. (plus 6.7 millions uah. of funds from the special fund)

Based on what has been mentioned above, it is possible to make conclusion that after the acting Government came, financing of the State program on providing youth with habitation was not only stabilized, but the volumes of financing have considerably increased too. As of 01.09.2004 from the state budget the Fund is financed for crediting in the sum of 65.3 millions uah., that makes 100 % from the annual planned purposes for the present period.

In total, for 6 years of Fund's activity, the Fund has provided with habitation by means of different mechanisms of support in receiving long-term credits for construction and habitation purchase more than 6,2 thousands young families. The program has received nation-wide development. For the past and this year 25 oblast programs on providing youth with habitation and the program in the city of Sevastopol have been approved as well as 43 regional programs and 31 city programs providing youth with habitation. Besides, it is worth noting that it's in 2003 began the essential growth of volumes of financing of the State program on providing youth with habitation from the funds of local budgets.

The common work of the State Fund for the Assistance to the Youth House-Building and the Cabinet of Ministers of Ukraine assists to the introduction of new forms and mechanisms of long-term housing crediting. Namely: in the last year the Fund, for the first time, introduced the mechanism of credit granting in the secondary housing market, corresponding changes were made to the Provision on crediting approved by the resolution of the Cabinet of Ministers of Ukraine.

Besides, the resolution of the Cabinet of Ministers of Ukraine "On approving the partial reimbursement of interest on commercial banks loans to young families and lonely young citizens for construction (reconstruction) and habitation purchase". At present, around 500 credits with partial reimbursement of interest have already been given.

For 2005 the Government of Ukraine plans to allocate funds from the state budget for realization of the State program on providing youth with habitation totaling 220 millions uah.

CHAPTER 12. DEVELOPMENT OF MORTGAGE SYSTEM IN KAZAKHSTAN

by
Anuar Karpykov*

Introduction

The development of Kazakhstan housing attitudes began in 1991 after the acceptance of legislations on privatization and property. Later, acts were accepted for a pledge of investment activity, the new Civil code, the decrees of the President of the Republic of Kazakhstan validated laws on the mortgage of real estate and the state registration of the rights to real estate and its transactions. These fell under the laws of the Republic of Kazakhstan on housing attitudes.

With the aim of creating mechanisms for housing construction financing, solving of housing problems for wide layers of citizens, reduction of prices on housing and stimulation of construction of housing, the governmental order of Republic Kazakhstan #1290 "From 21 August, 2000 has approved the concept of long-term financing of housing construction and development of mortgage crediting in Republic of Kazakhstan." The concept stipulates an opportunity for attracting independent resources from creditors by issuing and distributing mortgage securities under condition of their covering, i.e. the two-level system of the mortgage loans, providing creditors with financial resources due to the means involved in the secondary market through specialized operators.

With a view to the practical realization of the long-term financing concept of housing construction and development of system of mortgage loans the decision to create a similar structure – the "Kazakhstan Mortgage Company " was accepted by National Bank of Republic Kazakhstan.

Basic examples of the organizations with this concept of functioning were considered during the creation of the Kazakhstan Mortgage Company, such as the American agency "Fannie Mae", German savings and loan associations and Malaysia corporation "Cagamas Berhad ".

1. Economy of the Republic of Kazakhstan

Kazakhstan, a part of Central Asia, is located almost in the centre of the Eurasian continent, and borders on Russia, Turkmenistan, Uzbekistan, Kyrgyzstan, China. The area of Kazakhstan 2,717,300 sq. km, with a population of over 15 million.

Kazakhstan possesses large stocks of oil and gas, nonferrous metals and other minerals. The current priorities for investment direction are: a fuel and energy complex; a building complex; a financial infrastructure; transport and telecommunications and a social infrastructure.

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Billion tenge

Year	1997	1998	1999	2000	2001	2002	2003	2004
GDP	1672	1733	2016	2600	3251	3776	4450	5542.5
Investments	119	189	277	519	776	1193	1259	1530.6
Export	6899	5871	5989	9288	8928	10066	13233	17989
Import	7176	6672	5648	6848	7607	7646	9145	11550
Budgetary deficiency of % of GDP	-3.7	-3.7	-3.7	-0.1	-0.4	0.03	0.7	N/A
Price index	11.2	1.9	17.8	9.8	6.4	6.6	6.8	6.9
The exchange rate (tenge / dollar)								130

Economic development of Kazakhstan is characterized by development of the basic macroeconomic indicators; the economy shows stable and regular increase of GDP in comparison to earlier. Average increase for the period 2003-2004 has reached 9.4%. For the year of 2004 GDP reached the sum of 5,542.5 billion tenge.

Also, a positive parameter is the growth of volume of investments into economy RK. Dynamics of investment growth shows that for the period of 1997-2002, the average indices equaled 59.20% showing a growth of 10.6% for the period 2003–2004.

For the period 2002-2004, inflation was under control and varied at a level of 6.4-6.8%. The forecast of National Bank RK for 2005 is 6%, a rather stable rate of inflation. This promotes an expectation of foreign investments stability and comprehensible rates of mortgage loans. The fixed capital investments performed positively and the growth of income of citizens, due to opening new workplaces, improved the base of mortgage loans. In activity KMC considers various methods of elimination of consequences of inflation, among them the hedging of inflationary and percentage risks, the application of alternative financial tools and the search for new sources of investments.

2. The Purpose of the Company

The purpose of the activity of JSC «Kazakhstan Mortgage Company» (KMC) is the refinancing of banks to purchase the rights of the requirements under mortgage loans.

The development of the mortgage loans market is primarily directed at the stimulation of accessible mortgage loans through the reduction of interest rates and comprehensible conditions of loans aimed at the lowest and middle class citizens of the country. KMC is non-banking financial organization, and its primary activity is directed at financing banks and other credit organizations which give out mortgage loans to citizens for the purchase, construction and repair of housing (which plays an important role in financing sphere development of housing construction) and stimulation of accessible mortgage loans for citizens in the Republic of Kazakhstan. KMC is the state tool for creating accessible mortgage loans. It has been assigned the responsibility for the expansion and introduction of the state program of mortgage loans as well as developing a share of securities markets by release of mortgage bonds.

3. Structure of Mortgage Loans KMC

JSC « Kazakhstan Mortgage Company » was created by the National Bank of the Republic Kazakhstan in 29 December 2000. Since 2001, the Company has successfully taken root in the process of mortgage loans and has led a leading position in this area of financial services.

The mechanism of KMC's mortgage loans is as follows: the company signs agreements on joint activity with commercial banks and the financial organizations which provide mortgage loans. According to agreements the Company redeems from banks - partners the right of the requirement under mortgage loans. Thus KMC completely compensates the sum of the credit to bank-partners. The borrower makes monthly repayments with interest, but payments to KMC come through the bank - partner as it is they who carry out confidential management of the requirement rights under the loan, for which it receives a part of the compensation paid by the borrower.

Under the mortgage loans the credit risk is also assigned to the bank. In the case of a default on the part of the borrower, the bank redeems rights of the requirement under the credit from KMC back.

KMC lowered interest rates amongst commercial organizations, by promoting the development of competition between the banks which are providing mortgage loans. For example, by the beginning of 2001, loans were no more than 3 years, and interest rates in national currency were 28% annually. When the Company began operating, the annual interest rates had decreased to 18-19% and loans began to be given for the period of 10 years. Now maximun loan maturity has been increased to up to 20 years, and rates have decreased to 13.6 % annually (at some banks - partners down to 12.6%).

Since it was established three years ago, KMC has essentially increased availability of mortgage loans to the citizens, and therefore, the demand for them.

4. Results of Activity KMC for 3 Years

As a result of the general stabilization of economy growth in the country, the expansion of an internal investment base and also the release of mortgage bonds, depreciation of involved investments for development of mortgage loans has been achieved. In turn, it has allowed for a considerable lowering of rates of compensation under mortgage loans and an increase in the availability of loans to citizens under the program of the Kazakhstan Mortgage Company.

For the three year period 2001 to 2004, KMC financed, in all regions of Kazakhstan, mortgage loans amounting to the sum 31 billion tenge. Therefore more than 16 thousand families have received mortgage loans, interest rates on mortgage loans have decreased from 28% to 13.6%, and period of loan repayment has increased from 3 to 20 years. Due to the support of the Kazakhstan Fund of Warranting of Mortgage Loans, the initial advanced payment has decreased from 30% to 10%.

In December 2004 the total sum of mortgage loans amounted to 151,297 billion tenge, of which KMC's share was 17% from the total sum.

The introduction of a control system on actives and passives, focused on the best foreign models, has allowed to provide profitable part in KMC assets, and in the sum on results of 3.5 years the accumulated to 631 million tenge of net profit.

KMC works with all commercial banks. The number of bank-partners has increased up to 15 (13 banks and 2 non banking organizations).

KMC, for the first time in the CIS countries, has carried out the release of mortgage bonds, and by December 2004 their volume has reached 25.6 billion tenge. The given program on accommodation of mortgage loans is one of the most unique and advanced in the CIS, and the demand of investors for KMC bonds, as a rule, considerably exceeds their offer.

It is obvious that for three years of activity KMC availability of mortgage bonds to citizens has essentially increased.

Requirements to Mortgage loans and banks-partners

Company purchase from banks the right of the requirement under the mortgage housing credits, adequate to the following characteristics and requirements:

- loans should be long-term, i.e. given for a term greater than three years;
- loans should be given to citizens RK, thus the borrower is obliged to get the property or take a loan to repair real estate (except for the ground areas), including other owner (e.g. to the guarantor)
- the minimal sum of the mortgage loan from 300 thousand tenge and can be established by the decision of the Company for each region separately;
- the sum of the basic debt and repayments on it are paid monthly as annuity payments;
- the real estate transmitted to a pledge, should be insured (insurance of risk of loss (destruction), damage of property), thus the insurance sum can't be less than sum of the rest of the basic obligation under the contract of the bank loan;
- the borrower (the physical person) should insure the life and work capacity on all validity of the contract of the bank loan;
- cost estimation of mortgaging property should be made by an independent appraiser possessing the corresponding license for the right of realization of estimated activity, according to the legislation of Republic Kazakhstan;
- the mortgage of the real estate should be registered at the "Real estate registration center"

The compensation paid by the Company to the bank-partner under the "contract of asset management of the rights of the requirement under mortgage loans", includes service charges of mortgage loans and the obligation of the return repayment under the given loans. The rate of commission is stipulated by the parties in the contract of asset management and in the contract of cession and established in percentage items from the rest of the basic debt under the mortgage housing loan.

The company has the right to establish limits on the purchase of mortgage loans for banks-partners. Thus purchase of mortgage loans can be carried out under the initiative of each of the parties.

Conditions for mortgage loans reception

The potential borrower interested in reception of the mortgage loan under the program of the Company chooses for itself one of banks-partners of the Company, from whom they receive the full information on mortgage loans and pass a preliminary qualification. Preliminary qualification of the borrower includes granting full information on conditions of crediting. During interview with the potential borrower, necessary explanations and consultations regarding terms of granting and repayment of the mortgage loan, the rights and duties of the parties (the creditor and the borrower) are carried out. The purpose of preliminary qualification is to inform the potential borrower of opportunities of obtaining the mortgage loan and about the concrete conditions of granting of the loan.

Having passed the preliminary qualification, the potential borrower has the following opportunities:

- reception of a mortgage housing loan without an initial payment, in case of granting by the borrower of the additional real estate

- receptions of a loan of up to 85% in the case of insurance of the civil legal responsibility;

- receptions of a loan in size up to 90%, in the case of signing guarantee contract with the "Mortgage Guarantee Fund of Kazakhstan";

- in the case of insufficiency of the income of the borrower attraction co-applicant (which quantity has no limit) or the guarantor individual or legal entity

Passing the preliminary qualification to the bank-partner, the sum of the mortgage loan is defined and enables the borrower to choose the real estate suiting his requirements on the market and to plan monthly charges in view of repayment of the future loan.

Interest under credits is formed taking into account an index of inflation and the credit of a spread bank fixed for the whole period. Interest rates under the credit are floating and reconsidered twice a year on April 1 and on October 1, depending on the change seen in the annual index of inflation (for last 12 months).

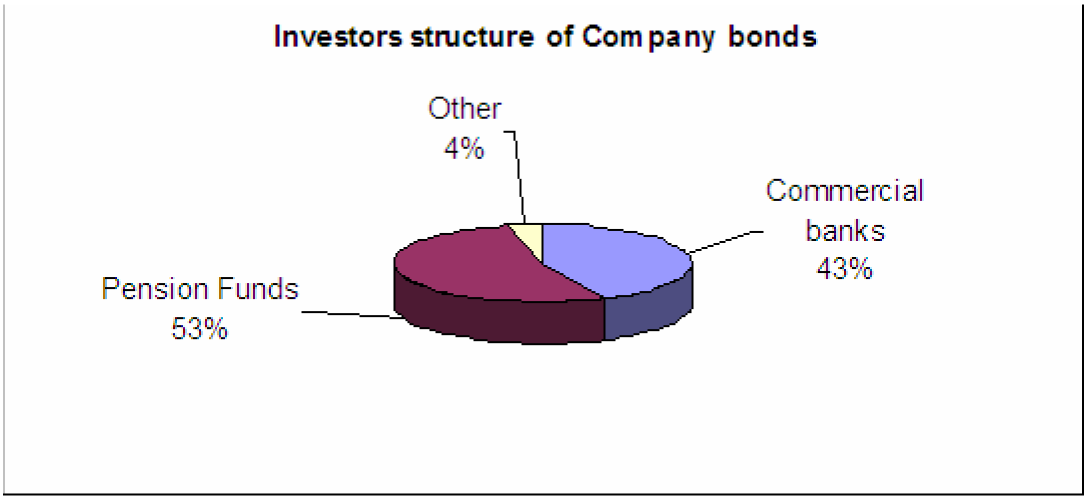
The company, on the basis of studying the international experience, develops the mechanism of protection against uncontrollable increase in interest rates, using of the top limit of the rate of compensation (cap). The top limit of interest rate - the maximal value of the rate which can be established to the borrower, without dependence from the economic situation. According to a technique authorized by the National Bank of the Republic of Kazakhstan, within a calendar year interest rates cannot be increased by more than 4.5 per cent, and this is only in the case of a significant growth of the index of inflation.

5. The Secondary Mortgage Market

Results which have been achieved in Kazakhstan in the system of mortgage loans within last three years would have been be impossible without the development of the mortgage bond market - a source of financing the system of mortgage crediting.

Since 2002, in the Kazakhstan funding market, investors essentially use a new financial tool - mortgage bonds. Activity carried out by the Kazakhstan Mortgage Company has served in the given direction both in the development of the system of mortgage loans of the republic, and a variety of financial tools of the securities market.

Analysis made by Kazakhstan Mortgage Company in December 2004, according to the statistical data of Agency of Republic of Kazakhstan, on regulation and supervision of financial markets and financial organizations (AFR) testifies that pension funds are the basic holders of mortgage bonds - more than 50% of KMC bonds.



One of the basic objects of an investment of pension money is corporate bonds of the Kazakhstan emitters. Though the market of non-state bonds constantly grows, it is necessary to note insufficiency in the share market of qualitative financial tools. Investments in the KMC agency mortgage bonds being a part of the market of non-state bonds of the republic possess the greatest appeal to investors as they have additional preference such as:

- bonds weighed on a 20% risk degree (other corporate bonds of domestic emitters - 100%);
- bonds included in structure high liquid assets
- bonds can purchased by participants of the pension market without dependence from own capital of the emitter;
- income of operations with bonds is released from the taxation, by analogy to the state securities.
- pledge of the bond is withdrawn from liquidating weight of the emitter and goes for calculation by investors

The potential for investment by pension funds in KMC bonds in view of established prudential specifications, is practically unlimited; now the volume of the money enclosed by pension funds in KMC bond goes from 0.14% up to 9.42% from a total sum of pure pension assets, with a maximum possible level of investment of up to 20%. Thus, only 2 out of 14 pension funds do not place pension actives in KMC bonds.

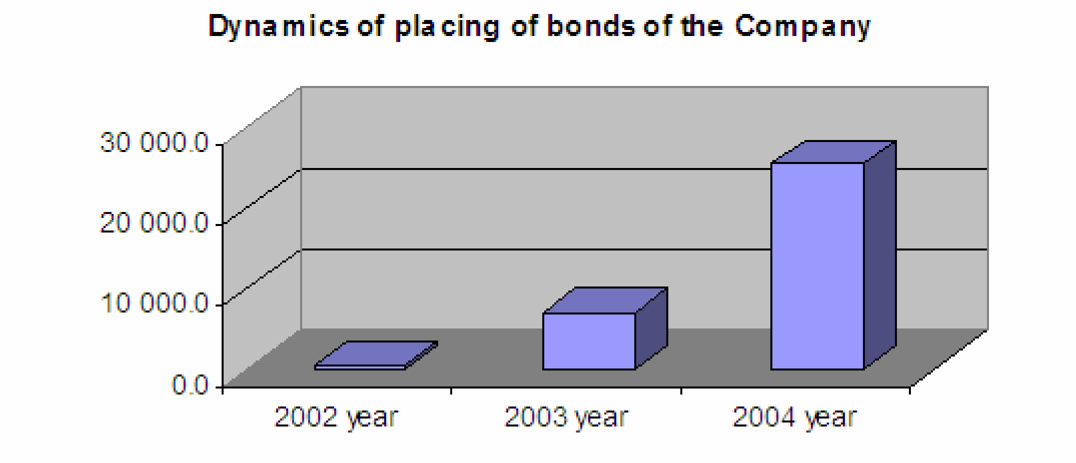
Name	0.14% – 2.50%	2.50% - 5.00%	5.00% - 7.50%	7.50% - 9.42%
Q-ty Pension Funds	3	3	3	4

What involves investors in mortgage bonds? Successful symbiosis of reliability, liquidity and profitableness. Presence of mortgage bonds in a portfolio of any investor allows effectively diversify risks at a sufficient level of profitability.

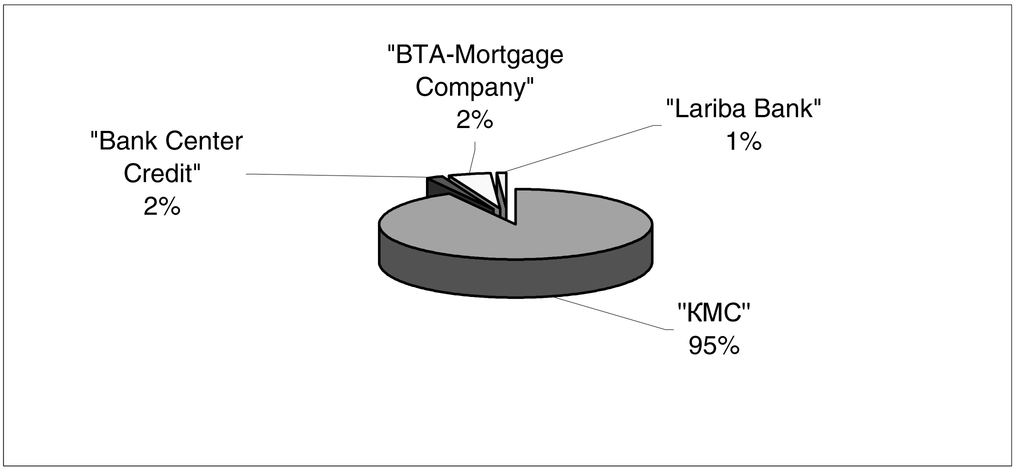
KMC mortgage bonds are the highly reliable and liquid financial tools that are provided with a pledge of a personal estate - the rights of the requirement under mortgage credits, which in case of bankruptcy of the emitter are excluded from competitive weight. Bonds are included in listing "A" on the

Kazakhstan stock exchange and have the status of agency securities which assumes clearing of surtaxes for holders of these bonds.

To date, KMC has released mortgage bonds totaling the sum of 25.6 billion tenge. In 2004, the additional registration of 5 issues has been placed.



The first emitter of mortgage bonds "LARIBA BANK" has appeared in 2001 in the market, in 2003 "BTA-MORTGAGE COMPANY" issued mortgage bonds (total amount of issue from 2001-2003 1,656 million tenge), and in 2004 "Bank CenterCredit " with volume 500 million tenge. Thus, 95% the of the mortgage bond market will consist of KMC bonds and it is possible to ascertain from this fact that there are no competitors in the market for KMC.



The rate of the coupon under bonds is floating and pays off on the basis of an index of inflation in annual expression. The rate is reconsidered twice a year according to change of an index of inflation. Thus it is necessary to note, that AFR has been proclaimed introduction of the responsibility of pension funds for negative profitableness on pension assets (in a percentage parity to the sum of own capital). Thus, the structure of the rate of coupon compensation under KMC bonds will allow supporting profitableness of pension assets at a sufficient level.

KMC Bonds have the top and bottom limits of rates of compensation (cap and floor), i.e. the maximal revision of the rate in the second fixed period can make 4.5 %. It means, that if there will be a sharp splash in inflation the next half-year interest will pay off on the top rod of the established corridor. And, on the contrary, in case of strong falling a rate of inflation, KMC interest will be paid within 6 months, proceeding from the bottom rod of a corridor. As soon as the stressful period will end, KMC will return to the former scheme of calculation of the investment income.

It is necessary to note, that KMC also for the first time has issued corporate bonds with term of the reference of 10 years that has allowed transforming KMC bonds in some kind of "benchmark" for other corporate bonds.

KMC constantly worked on creation of such structure of bonds which optimum would answer both to investors' interests and specificity of KMC activity. And, from one issue to another there was improvement of structure.

Under KMC forecasts, development of the market of mortgage bonds will proceed in the future. Thus, roughly, KMC in the near future can stabilize releases at a level about 2.0 billion tenge a month, and in the long term up to the end of 2005 - up to 5 billion tenge a month. The significant potential of internal investments of republic consists in the further realization of pension reform which gives a positive pulse to development of the funding market.

In March, 2004 the head of the state in the annual message to people of Kazakhstan has proclaimed necessity of development of a new policy of housing construction. In particular, the purpose to put into operation up to the end 2007 12 million square meters of housing has been determined, that is to increase annual input of housing on the average twice to a level of 2004. Accordingly, prospects of development of the market of mortgage securities in Kazakhstan look optimistically.

For financing mortgage loans within the framework of the State Program of development of housing construction in RK in 2005-2007 KMC plans to release bonds in volume 146.1 billion tenge, from which 34.9 billion - in 2005, and 111.2 billion tenge - per 2006-2007.

6. Mortgage Insurance System

In order to increase citizens prosperity by creating access to mortgage system, "Mortgage Guarantee Fund of Kazakhstan JSC " (further Fund) was funded under the initiative of National Bank of Republic Kazakhstan which appeared as unique founder . The primary goal of establishment and functioning of Mortgage Guarantee Fund of Kazakhstan JSC the National Bank of Republic Kazakhstan sees in:

- creation of favorable conditions for increase in term of the mortgage credit;
- decrease in a level of their interest rates, increases in the sizes of credits and decrease in size of an initial payment at mortgage loans;
- formation of system of guarantee of mortgage credits and a corresponding segment of the insurance market.

The fund is the self-financed organization which basic income should become payments under contracts of guarantee of mortgage credits.

It is necessary to note, that requirements of Fund on guarantee mortgage credits have been developed on the basis of requirements of the Kazakhstan mortgage company, in the same time work and under own programs of banks is planned. Mortgage guarantee considerably reduces the credit risk of banks connected to a default of the borrower, and in many cases, it can exclude this risk completely. Because

Mortgage Guarantee Fund of Kazakhstan JSC divides this credit risk, banks can offer the expanded portfolio of mortgage credit products focused on more broad audience of borrowers.

According to the State program of development of housing construction for 2005-2007, these three years will see more than 12 million sq. meters habitation contrusted. Housing construction has been called to become one of the priority directions of the development strategy of Kazakhstan until 2030, and is one of the most important problems of national character. Maintenance of a steady rate of growth in housing construction, accessible across the board to citizens is impossible without a reduction in cost, an increase in housing credit and a decrease in initial payments and rates of loans. The given purpose can be achieved, through the development of the system of mortgage loans and the guarantee of mortgage loans.

7. Government Support

The state program of development of housing construction during 2005 – 2007 plays a very important role in solving complex problems in this domain, providing the availability of housing to citizens and certainly plays one of the most important roles in the developing mortgage system.

The state housing development program, Kazakhstan Mortgage Company (KMC), is entrusted to develop the Special Program of mortgage crediting of accessible housing. KMC tries to generate more comprehensible conditions of mortgage housing credit for wide citizens from disperse socio-economic groups.

Mortgage loans under KMC Program will be provided to the citizens upon purchase of accessible housing whose cost will not exceed the sum equivalent to 350 US dollars per m^2 which follow the conditions of, and according to, the basic requirements of KMC to mortgage housing loans. Mortgage credit under the State housing program will be made in all areas with the accessible housing planning to be built in all regions of Republic.

The state housing development program provides, first of all, stimulation of solvent demand due to reduction of interest rates, decrease in an initial payment and increase loan terms. The realization of accessible housing under the State program is governed by local agencies authorized by the Government.

8. Risks of Mortgage Loan in Kazakhstan

The company closely watches risks which can damage the interests of investors and the Company, monitors and analyses the current condition of the market for this purpose. There are various kinds of risks which can negatively affect on KMC and for this purpose, as methods of estimation, the following tools are used:

The credit risk - credit risk is actual for the Company in case of bankruptcy of the bank - partner is ordered to prevent that risk the company established special financial condition to bank - partners.

The risk of prescheduled repayment - is applied the moratorium on prescheduled repayment and collection of a commission for prescheduled repayment.

The risk of liquidity of assets - for restriction of the given kind of risks by the Company is created a liquid stock which consists of the state securities intended for sale with the purpose of full and duly repayment of obligations. It is necessary to note that if the size of a liquid stock exceeds the maximal sum of lump sum payment under obligations to investors on all released bonds.

The percentage risk - Regulation of the given risk is carried out by use floating interest rates under loan and bonds. Thus as a basic index inflation is used.

The inflationary risk – if a substantial increase in the rate of inflation takes place, an increase in the quoted rate that can result in reduction in demand of borrowers for mortgage housing loans, and also growth of number of defaults.

Risk of devaluation - In connection with that assets of the Company, the rights of the requirement under mortgage loans are received by the Company in tenge, and passives, emitted in bonds, are nominated in tenge, the risk of devaluation is absent. The given risk can arise at decision-making to involve to the international market and attract investments in a foreign currency.

The risk of liquidity of a security paper in the fund market - the given risk arises in case of the impossibility of selling bonds in the financial market. Restriction of the given risk is a guarantee of good financial performances of obligations to bonds holders (a pledge of a personal estate - the rights of the requirement under credit obligations of borrowers), reliability of the Company (performance prudential the specifications established by Authorized body), the appeal of the given bond following from its status « an agency valuable paper » (it is distributed all releases of mortgage bonds of the Company, except for the first release) and so forth.

Risk of the competitive environment - the Mortgage loans offered by the Company, have a number of advantages compare to other commercial banks offer and the financial organizations that make their more attractive to potential borrowers, namely:

- Rather low rates of compensation;
- Nominated in tenge, without fixing their currency equivalent;
- Long term (20 years);
- Repayment of annuity payments.

All this allows that the substantial existing demand for mortgage loans will become covered due to the activity of the Company.

Alongside the KMC program, commercial banks offer their own mortgage loan products in tenge, and other currency (mainly in USD).

9. Products of Crediting of Housing Loans

Now, as their primary activity, KMC plans to carry out three degrees of operational work on mortgage loans.

1) The Market program on purchase and repair of housing

- loan period from 3 to 20 years
- currency of loan - tenge
- the sum of the loan from 300 thousand tenge and higher

- the rate of compensation - floating, on occasion fixed (revision 2 times a year)

- the size of an initial payment of 15% of the cost of the house, under conditions of insurance of the general liability, it is possible to grant the sum at a rate of 10% and more, in the case of a guarantee of the credit with joint-stock company « Kazakhstan Fund of Warranting of Mortgage Loans».

2) The special program on purchase of accessible housing

- the interest rate - 10%;

- an initial payment - not less than 10% of the cost of the house;

- loan period - 20 years;

It is the state housing development program which provides first of all a stimulation of solvent demand due to reduction of interest rates on the basis of: fixed rates, the reduction of the size of the initial payment and the increase of the loan period.

3) KMC plans to cover the share market by selling mortgage bonds up to 221.9 billion tenge from 2005-2007. This will create an additional stimulus for development of the market share, and investment in the Republic of Kazakhstan.

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

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Housing Finance Markets in Transition Economies

TRENDS AND CHALLENGES

Capital market and banking sector reforms have been proceeding at different speeds and scales in transition economies. Housing finance markets in this region are typically small in scale and under-developed, though it is generally recognised that fostering housing finance markets contributes to economic development and brings social benefits to the public. Taking account of the unfavourable environment for households in terms of income level, house prices and loan interest rates in the region, enhancing access to housing finance for low- and middle-income households is a key to developing these markets. In particular, mortgage lending that makes use of the property as collateral is a very important method of housing finance in terms of risk management in the region.

Housing Finance Markets in Transition Economies contains a comparative study on housing finance markets in central and eastern European countries. This study is based on an OECD market survey conducted in 2004 and on selected country data prepared for the OECD workshop on housing finance in transition economies, held in December 2004. It reports on the progress and challenges in housing finance markets in Croatia, the Czech Republic, Estonia, Hungary, Kazakhstan, Lithuania, Latvia, Poland, Romania, the Slovak Republic, Slovenia and Ukraine.

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