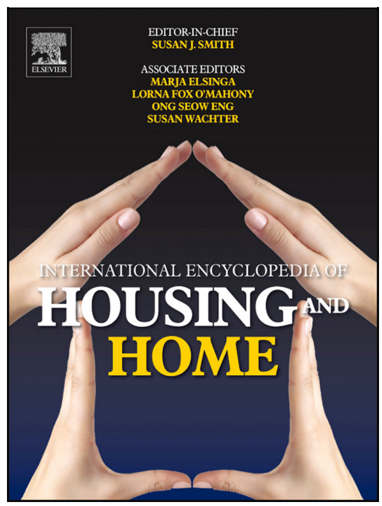

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Housing Finance Institutions: Transition Societies

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Glossary

Housing funds Designed as public or semipublic entities to help finance the construction of a social rental sector.

Mortgage-backed securities Debt obligations, which represent claims on cash flows from pooled mortgage loans. These obligations are bought from financial institutions (mostly banks) by governmental, private, or semiprivate entities, which in turn issue securities based on the claims of payments of the basket of pooled loans.

Public–private partnership In housing this describes an integrated approach wherein private companies fulfil public service obligations, such as housing provision for defined households with need. For this purpose they have access to public funds (state aid). Successful PPP models are in place in several Western European and Asian countries, but hardly in any transition economies.

Social rental sector Part of housing provision set up with the goal to satisfy the needs of those income classes that are excluded from homeownership or the open market rental sector.

Structural Funds From the EU Structural and Cohesion Funds the European Regional Development Fund (ERDF) is most important in terms of housing. Today it is possible to spend a small portion of it on housing refurbishment issues.

Structured housing finance products These were developed to mitigate risks and reduce costs of capital. They can be defined by three key characteristics: pooling of financial assets, delinking of the credit risk of the asset pool from the credit risk of the originator, and tranching of liabilities that are backed by the collateral assets.

Introduction and Background

After the shaky economic developments in the 1990s most transition economies entered a phase of stability in the past decade until recently. In line with overall economic development the financial structure also faced massive changes, which were accompanied by numerous banking crises and credit crunches. While these widely underdeveloped banking structures were reconciled, the structure of housing finance did not seem to modernise (see among others OECD, 2005; UNECE, 2005). In the current crisis all transition countries are affected by an economic downturn although the effects differ in intensity. For most housing markets the current slump is even more harmful than for the average of Western European countries, although economic actors are affected differently. Compared to some Western economies, households have fewer negative effects when they became homeowners after transition. Conversely, housing supply is under even more severe pressure than in many Western European economies. The reasons for this can be found in the housing supply structure and development of housing finance products.

In the first years of transition numerous economies privatised their formerly public or cooperative housing stock and enabled renters to become homeowners. In some countries more than 30% of the housing stock was privatised (PRC, 2005). Homeownership rates rose and are well above EU15 average, while retail financing products appeared only in the early 2000s. They were responsible for a boom in new construction of housing in all metropolitan areas. But the excessively high ownership rates derive primarily from high rates even before transition and privatisation.

For many years new construction of multistorey dwellings in Central and Eastern European (CEE) countries was largely orientated towards the upscale condominium market. There was neither hardly any social housing construction nor rental housing construction. International investors, (domestic) construction companies, and the banking sector with its newly developed retail mortgage products were the major players in housing development.

For a discussion on development in residential debt to GDP ratios and rationale for homeownership in CEE economies see among others Amann (2005). As shown in **Figure 1**, the residential debt to GDP ratio in CEE and Southeastern European (SEE) countries remains well below the level of advanced European countries and the United States. Despite the small size, the lending market for housing in the region has grown sharply, with an average growth of well above 50% per year. In the

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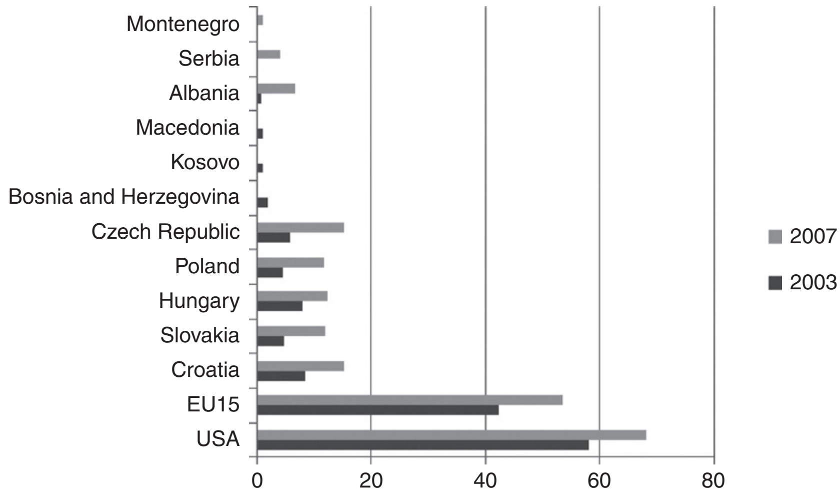

Figure 1 Residential debt to GDP ratio in percentage in Central and Eastern Europe in comparison to the United States and EU15 for 2003 and 2007.
ECORYS (2005), EMF (various issues), IMF (2008), and own calculations.

EU15 countries, the growth rates were mostly less than 10% in the same period, but starting from a much higher level (OECD, 2005).

Therefore this article first gives a short overview of the main developments in the banking sector, which are classified as a traditional view of housing finance institutions. But they can only partly comply with the financing needs of social housing in CEE economies. Hence, focus is laid on alternative views of housing finance and the role of different housing finance institutions. In this respect national and international finance institutions are distinguished.

Traditional View on Housing Finance Institutions

The necessity for developments in housing finance was not primarily driven by an increased demand for financial means, but was fostered by international commercial banks to enlarge their business share in CEE economies. In this respect especially international financial institutions such as the European Bank for Reconstruction and Development (EBRD) have been of high importance for the promotion of liberalised housing finance markets.

Banking Institutions

While the efficiency of the banking sector was improved in all CEE economies in major consolidation phases in the late 1990s that led to a sharp increase in the market share of foreign banks, the efficiency of the legal background followed an individual national basis. Both aspects, the deepening and restructuring of the banking sector itself and the accomplishments regarding the efficiency of mortgage lending, vary substantially across CEE and SEE countries. In a cross-country analysis that measured the legal efficiency of national mortgage markets at the multidimensional level, countries like Croatia, the Slovak Republic, and Slovenia reached the best score (EBRD, 2007). This means that in these countries the mortgage system developed more efficiently compared to Poland and Serbia, but also compared to Hungary and the Czech Republic. Despite these differences between transition countries the overall increase in efficiency is acknowledged. Mortgage lending in CEE/SEE economies by financial institutions was further improved among others by the introduction of contract saving schemes, following to a large extent the system of Bausparkassen, which was implemented with different success in the Czech Republic, Slovakia, Hungary, Romania, and Croatia in the 1990s, or by the set up of specialised mortgage banks.

Development of Structured Products

Similar to indirect finance systems the institutional structures of housing finance too have to fulfil the basic function of providing liquidity. As mortgage finance systems deepen, different forms of structured finance products emerge, despite changes in the underwriting criteria of mortgage lenders like maximum loan to value ratios. Lenders in CEE and SEE countries show great interest in the securitisation of mortgage loan portfolios. In Romania, for example, several laws were passed or adapted in order to facilitate mortgage-backed security (MBS) issues. Still in other countries like Serbia, Bosnia and Herzegovina, Montenegro, Kosovo, and Albania, capital markets are in a very early stage of development and, thus, cannot yet serve as a resource for long-term finance. However, it is likely that, in the next few years, these countries will reinforce their efforts to develop these markets by enacting the necessary legislation and establishing the relevant institutional framework (e.g., supervisory bodies).

Impact of International Financial Integration

The impact of increasing international financial integration for CEE economies mainly covers two aspects: to diminish interest rate spreads in combination with an increase in efficiency in local mortgage markets and to increase mortgage lending in foreign currency (until currently). Competition among banks together with an increase in the respective banking sector's depth and financial support of the EBRD in terms of loans, equity, and guarantees decreased interest rates on mortgages and increased the flexibility of existing mortgage products. This counts especially for the new EU member states and to an even larger extent for the new member states of the Euro zone. Another aspect of international financial integration that pushed mortgage supply was the increase in mortgage lending in foreign currency. Especially Romania, Poland, Hungary, and Croatia took advantage of this possibility of lending in the past years. Following the current financial and economic crisis, foreign currency loans turned to be very problematic. In some cases, at the time devaluation of the local currency increased mortgage payments, real estate market slump reduced the value of the dwelling and jobs became insecure. Today, foreign currency loans are mostly prohibited or discouraged. Existing loans had to be converted.

Housing Finance Institutions at the National Level

The possibilities of public authorities changing the market results of demand and supply on the housing market are multidimensional. The role of the state can be manifested by direct and indirect housing subsidy schemes as well as tax incentives. For the question of housing finance especially, state guarantees, tax reliefs on income tax, and legal action are important. Furthermore, the respective national institutional setting accounts for specific financial funding possibilities.

Figure 2 shows different forms of organisational structure of housing finance at the national level. Moving from structures of mortgage providers, which might be pure market actors as well as state administrated entities, to state guarantees, national housing

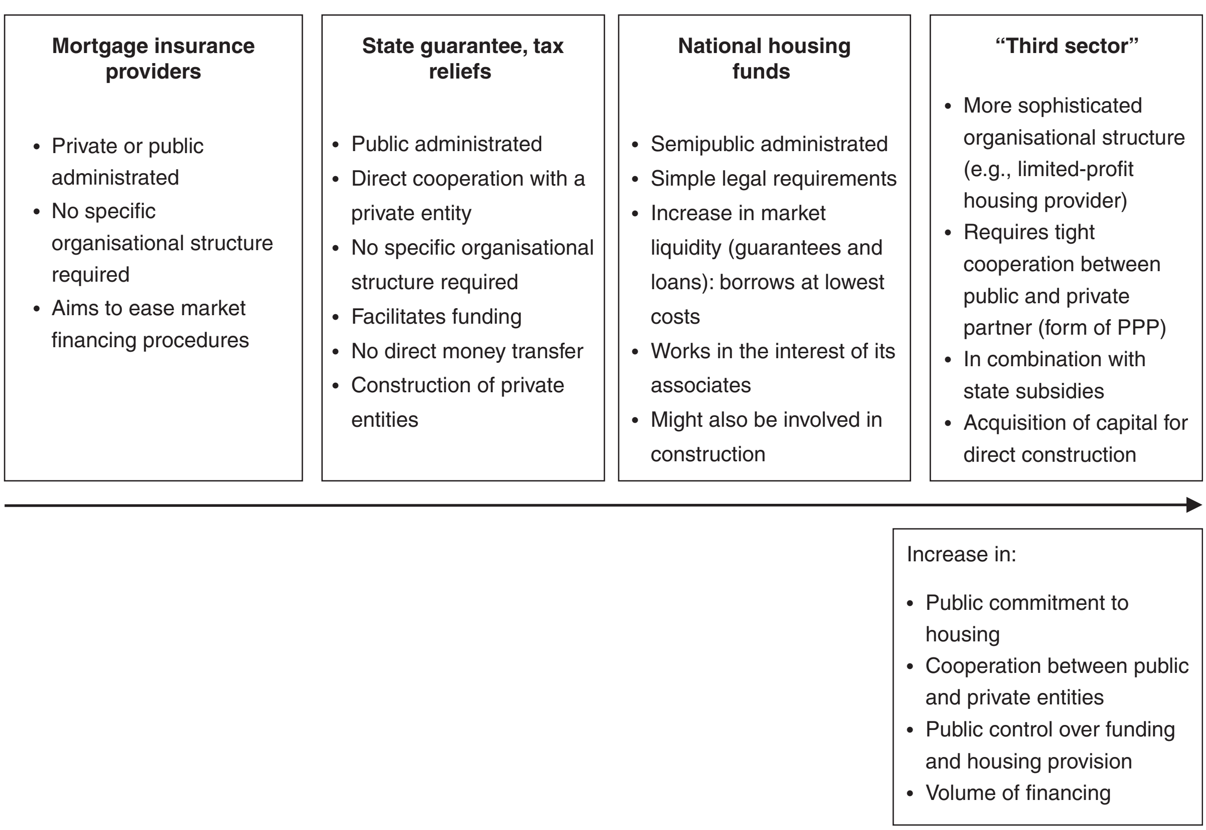

Figure 2 Housing finance: Organisational structures at the state level.

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funds, and to a so-called 'third sector' in housing finance, housing provision requires a stronger cooperation between public and private entities. In the following section the use and structure of these different organisational forms at the state level in selected CEE and SEE countries are discussed.

State Guarantees and Tax Reliefs

While public funding is constrained by national and international fiscal requirements, public guarantees are less affected by these constraints and can serve as important factors for cheap housing finance, as investors benefit from the creditworthiness of the public sector and financing security is increased. As all transition economies have tight limits in providing guarantees, which they might also allocate preferable to other investments but housing, the effectiveness of state guarantees is limited. A precondition for the success of state guarantees is the supervision of provision, which includes the fact that only institutional finance should be provided via this channel, as negative effects on payment behaviour may be caused when private persons are the immediate beneficiaries. Alternatively, structures of tax reliefs can be chosen to obtain similar well-guided financing effects for private households. Unlike direct monetary subsidies by the state, which are designed as unconditional grants, tax reliefs promote the financial capacity of the individual household. In this case the financial sector is not enlarged; however, it can be shown that homeownership financing for households becomes more attractive (Springler and Wagner, 2009).

CEE countries like the Czech Republic, Hungary, and Slovakia introduced such schemes already in the 1990s and used it throughout the past years to a different extent. In Hungary, for example, the mortgage payment allowance on personal income tax had no major influences when introduced in 1994, but with the discussions and structural changes in 2000 and 2002, which led to a substantial increase in tax deductibles and widened the base for deductions, its impacts for loan demand increased (Hegedü, 2009).

National Housing Funds

Some Western European and a growing number of CEE/SEE countries use the instrument of housing funds. A particularly successful example is the Dutch Waarborgfonds Sociale Woningbouw (Social Housing Guarantee Funds), which was set up already in the 1980s and provides a triple loan guarantee (through the structure of the association, the capital assets of the fund, and the state and local authorities) (Boelhouwer, 2003).

A housing fund may issue loans, grants, or guarantees for the rental sector as well as offer a finance possibility for homeownership. It may work more efficiently than public administration, presuming that its mandate and control are properly regulated. For such a fund, public guarantees may be an appropriate and cheap form of public commitment, but, at the outset, direct public funding seems to be indispensable, at least in the initial phase. The effectiveness of such a fund is dependent on its size. The national housing funds in place rely partly on revenues from housing privatisation, partly on loans of international financing institutions, and partly on budget grants as sources of their capital. Especially Poland, the Czech Republic, Slovakia, Slovenia, Romania, and Albania take advantage of national housing funds as funding source. The Housing Fund of the Republic of Slovenia emerged as an important provider of finance for the social housing sector after transition, when mortgage finance was developing slowly and housing policy was inadequate. The Polish National Housing Fund (KFM) has financed since the mid-1990s, when it was established, more than 60 000 new rental units. The administration of the fund is done by the state-owned Bank Gospodarstwa Krajowego (BGK) (Chiquier and Lea, 2009). By 2006 around 60% of the fund's volume had been funded by government budget grants (World Bank, 2006). Despite the current crises, discussions to promote the fund's stability were ongoing in the last years; possible strategies include the aim to narrow the gap between KFM loans with market conditions and the search for new alternative forms of public–private partnerships (PPPs). Such measures reshape the tasks of national housing funds from the provision of a social rental sector for lower-income classes to a broader provision for middle-income tenants.

A 'Third Sector' in Housing

Some CEE economies started in the last years with the establishment of 'third sectors'. As the developments of nonprofit and cooperative housing schemes for example in Slovakia and the Czech Republic show, which are rather restricted in their operations due to considerable political commitment or heavily criticised for their structure and forbidden after a few years in place, the establishment of a 'third sector' as a special form of the PPP requires a strong political commitment, a well-organised legal background, as well as provision of financial means. In Poland, a concentrated semiprivate nonprofit sector Towarzystw Budownictwa Spolecznego (TBS) (Society for Social Housing) is responsible for rental housing construction and receives financial support from BGK bank, the National Housing Fund, and in the last years from European Investment Bank (EIB) and Council of Europe Development Bank (CEB), which are presented in the following section, in the form of state guaranteed loans. A new approach to establish PPP for affordable housing is taken by the Austria-based IIBW – Institute for Real Estate, Construction and Housing.

Current projects in Romania, Montenegro, and Albania follow a dual strategy to establish a legal framework for this new business type with a PPP Housing Law and to develop a funding scheme including sources from international financing institutions.

International Financing Institutions

In addition to financial structures and institutions at the state level, the international financing institutions International Finance Corporation (IFC), a member of the World Bank, EIB, CEB, and others promote housing finance in transition economies. Furthermore, the European Union has an impact on housing developments in those transition economies that are already member states of the European Union within the setting of the Joint European Support for Sustainable Investment in City Areas (JESSICA) programme (see below).

World Bank/International Finance Corporation

The World Bank has followed closely the changes in housing policy in transition economies since 1990. It has carried out substantial analytical work (sector reports) and has worked closely with researchers and policy analysts across Central and Eastern Europe on all relevant aspects of housing policy reform. Financial support was granted to housing projects in Poland, Russia, Albania, and Latvia in the form of loans or guarantees (Tsenkova, 2005). In the last years (2004–08) especially land administration and management projects were financed in Montenegro, Serbia, and Bosnia and Herzegovina through the World Bank.

European Investment Bank

The EIB is the financing institution of the European Union and, as such, aims at providing long-term finance for specific capital projects. Housing projects, especially housing renovation, have traditionally found support in the context of the urban renewal objective, but recently a wider opening to social housing finance, in support of the social cohesion objective, has taken place. The EIB is involved in implementing EU development aid and cooperation policies through provision of long-term loans. These loans are derived from the bank's own resources, subordinated loans, and risk capital from EU or member states' budgetary funds. In 2002 for example, the EIB decided to lend a total of EUR 200 million to Poland for urban renewal and energy-efficient social housing. The 25-year loan to state-owned BGK is aimed at renovating housing stock that shows evidence of severe deferred maintenance. Investments are mainly concentrated in the urban areas with the largest housing deficits.

In addition to these direct financing methods of projects by the EIB, the bank has an important role in the JESSICA programme, which is described below.

Council of Europe Development Bank

The CEB especially aims to support housing policy measures for vulnerable groups and persons. In Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Serbia, Montenegro, Albania, and Romania, funds were invested in projects for the housing of refugees, the reconstruction of war-damaged dwellings, and the social integration of the Roma community. The bank is also contributing to large-scale public programmes for the construction of social dwellings and housing projects for young people and low-income families (Tsenkova, 2005: 99).

European Union: Structural Funds and the JESSICA Programme

In 2006, after several years of discussion, an agreement was reached that allowed European Regional Development Fund (ERDF) spending on housing under certain conditions. With this agreement direct financial support of social housing measures through the ERDF was made possible and replaced the only indirect assistance via the general engagement to support economic and social conversion in urban areas. In order to avoid the split-up of ERDF funds for housing issues among different programmes, overall housing-related expenditure should be limited to 4% (until 2009 only 2%) of total ERDF funds (Cecodhas, 2009). With the opening of the structural funds for housing measures, it has become clear that a need for action in CEE and SEE countries has been declared at the highest political level.

Unlike the traditional grant funding, JESSICA focuses on the support and development of financial engineering instruments in the field of sustainable urban development with the use of equity, guarantees, and subordinated loans. National Structural Funds managing authorities should establish urban development funds (EIB, 2007: 3–8) with grants from the structural funds and loans from the development banks – EIB and CEB. These urban development funds should in turn attract further national contributions, aim to find private capital investors, and invest in selected PPPs or other eligible projects for urban renewal. In addition to a national intermediary between urban development funds and the managing authority, a holding fund may be established. These requirements prove to be difficult to be implemented, worsened by the request to design integrated urban development plans, without being defined clearly.

So far, the implementation of the programme in the EU member states is in progress. But until June 2009 only two JESSICA agreements have been signed for CEE

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regions, namely the region Wielkopolska in Poland and Lithuania (Regio, 2009). The problems with the implementation of the JESSICA programme are pointed out clearly in the evaluation studies of the two projects: the unclear legal structure of the urban development funds, the weakly defined relationship of the involved institutions, and a lack of well-developed equity markets in CEE regions. Furthermore, the necessity to promote social housing in addition to urban renewal is clearly expressed.

Conclusions

In the light of the current financial crisis, which tightens the possibilities of conventional market financing in the housing sector, the impact of adequate national and international housing finance institutions is even higher. The experience of the last years in CEE and SEE economies shows that all economies try to overcome the gap in the social rental sector by implementing different forms of alternative finance. Housing finance structure has to be improved to be a stable market player in an integrated European housing finance environment. The European Union manifested in the last years its willingness to promote urban regeneration with the set-up of the JESSICA programme. Its real impact cannot be forecast as implementation is still on shaky legal grounds and financial funding has not reached the necessary level. An extension of the programme to social housing construction is urgently recommended. Furthermore, additional housing finance sources from PPPs ('third sector' of social housing finance, as represented here) seem a necessary alternative to the common sources of traditional housing finance.

See also: Cooperative Housing/Ownership; Covered Bonds; Economics of Social Housing; Housing and the State in the Soviet Union and Eastern Europe; Industrial Organisation of the US Residential Mortgage Market; Public-Private Housing Partnerships.

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