

# Housing Finance in South Eastern Europe

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## A. Introduction

1. Transition from the centrally planned economy towards the market economy has taken much longer than most of the observers had thought. The transition recession lasted almost 10 years for the most developed countries in the region, and the GDP in the „latecomer” countries has not even reached the pre-transition level. Housing is one of the most complex areas of the economy where changes take place more slowly than in other areas, especially in the field of housing finance. Housing starts in the most advanced transitional countries have not reached 80 % of the pre-transitional level, and housing finance is in a premature state.

The debate on housing in transition countries raised the issue of the possible roles of housing in transition. Two options were discussed: (a) housing as a shock absorber or (b) housing as an agent of changes (Buckley-Gurenko, 1996, Struyk, 2000, Hegedüs, et al, 1996, etc.). The experiences of the past few years support the approach that housing has not played an “independent” role in transition beyond privatisation, but was much more a consequence of the reforms in other areas.

2. The reform of the housing finance sector in the transitional countries has to deal with the legacy issues. Housing was considered to be part of “social goods”, and not a commodity. Even if this was more a part of the ideology and rhetoric in politics than a part of the reality of the socialist housing system (Hegedüs-Tosics, 1996), it has an important effect on today’s housing policy.

In the pre-transition period the typical financial institutions (if they existed at that time) were part of the state economy. Their “behaviour” was closer to state organizations (allocating subsidies and resources) than to market institutions. Typically, state owned banks were responsible for extending housing loans with very long maturities, low fixed interest rate regulated size of the loan, and there were no underwriting procedures. Loans were more a type of subsidy than loans; real estate developers were part of the state planning process rather than real estate markets.

The real hardship of the transition is that legal changes are not enough; a radical change of the behaviour of the institutions is needed as well. It requires the introduction of new incentives to force the institutions to adjust to the changed environment or setting up new institutions with new rules.

The households are just as important as the institutional environment. In the transition household attitudes have to be changed as well. They have to adapt to the new conditions. The changes of the housing expenditures, the housing prices, and the decline of real incomes, etc. have forced the households to adapt to the new situation. It would be very important to increase the role of the housing mortgages in the transition, as it is just the tool to encourage the thrifty long-term, “middle-class behaviour” as an element of the household adjustment process.

3. Housing finance -- that is, the financial issues of the housing sector -- relates both to the stock of housing and the investments part (both in new construction and in transaction). The housing policy, which segregates the new housing construction from the operation and maintenance is very ineffective as it lacks the basic understanding of the real estate economy. (Renaud, 1995) The importance of this statement is underscored by the fact that in most of the transitional countries the sector is in "deficit". The operation of the sector is not and could not be financed by the household sectors, and the state subsidy contribution is not enough for the "reproductions" of the stock. Households do not pay the bills for housing services, the state subsidies are decreasing as well, which leads to a steady deterioration process.

The institutional and management structure of the housing stock has an important effect on the speed of the transition. The service providers in the housing sector remained mostly within the public sector, although different outsourcing methods have been introduced. The restructuring of the old-fashioned maintenance companies in urban areas is an important task of the housing sector reform.

4. The South Eastern European countries are in a very different situation today, even if they had a common period of the socialist housing system, following the second World War, up until the beginning of the 1990s. (Hegedüs-Tosics, 1996) However, not even this can be considered as uniform across the countries, as Yugoslavia followed a special path of socialism (based on self-administration and open relations to the West), while Albania can be considered as just the opposite, having been the most separated, closed country among all. Croatia is in the best situation, which finished the war in 1993, and has the best chances to recover based on its high political stability in the region. Romania and Bulgaria have not been involved in the war, but were quite slow in structural reforms, which had a bad effect on their macroeconomic situation. The war in countries like Serbia, Bosnia-Herzegovina, and in Macedonia even in 2001, and political tensions have made today's situation quite difficult. The fragile situation in the region is illustrated by the Albanian financial crisis of 1997, a country which was considered in the beginning of the 1990s as a miracle of economic growth. But this growth was based on foreign aid and the remittances of the Albanians abroad, and not on the real structural changes. We cannot deem the political situation today as stable, the corruption and the general decline of the public sector have remained a critical issue.

5. New legal foundations and new housing finance institutions cannot be built up in an environment where the housing equities are insecure, in a situation where legal and enforcement procedures do not work, and the deterioration processes are not localised. A strategy for building up a new, market-based housing finance system should include the financial management issue of the stock as well. In housing finance the financial agent has a long-term commitment on both the demand and supply side, which depends very much on the long-term stability of the economy, and on the steady, uninterrupted development of the economy. Thus the reform on housing finance should be parallel to the reforms in the economy, and real changes can only be expected with the stabilisation.

## **B. Macroeconomic, institutional and legal background of housing finance**

6. The role of housing in the economy is a key issue in the countries of transition. Economics offer some insight into the relations of the housing sector and the macroeconomic situation which housing policy should utilise. (Buckley, 1989)

7. The role of housing in the economy is well demonstrated in the literature. Real estate represents a major capital resource for many individual households. It constitutes an important form of personal wealth, conditioning popular attitudes towards the state and the economy. A soundly financed housing sector can play a major role in economic growth and economic stabilization through the creation of jobs in construction and materials, demand for new enterprises, the financial sector, and indirect impacts through subsidiary activities, including infrastructure, materials, furnishings and services. Housing costs, including housing related services, borne by households accounted for 15-25 % of GDP. A well developed housing sector can significantly mitigate unemployment, since housing shortages can severely restrict labor mobility. The low level of housing finance led to the lack of fluidity in real estate finance, which, in turn, slowed down the readjustment process of the labor force. A developed housing finance system allows capitalization of surplus resources in long-term real estate investments, which are relatively safe, protected from inflation and generate a stable flow of revenues. The need for such long-term investment opportunities arises in connection with the reform of the social security system and the appearance of pension funds. In the 1980s, real estate assets were estimated to constitute about 57% of capital accumulated in the world economy as a whole (residential housing accounts for about 41%). It was almost twice as much as the value of corporate shares and bonds combined. Sound housing finance and real estate sectors allow citizens to benefit from this capital thus providing the basis for further development of democracy and the free market economy. (Black, et al, 2000)

8. Housing (in a broader sense real estate) can act as a store of wealth by providing opportunities for investment in property assets. Housing is a special commodity being durable and immobile, which makes it a valuable store of wealth on a long-term basis. Real estate can be used in ways independently of any occupancy of it by the owner. Developed housing finance systems could use the equity locked up in real estate through mortgage lending, for example, and millions of owners might respond by borrowing against their property and investing it in various ways. This could be advantageous if it is accompanied with the higher fiscal discipline of the households. Household borrowings are very low in these countries compared with the western economies. The other related question is what the source of the mortgage funds is whether it is foreign investment or household savings?

9. In these ways, the real estate market and the financial sectors become interdependent. This can be both strength and weakness for the wider economy. The use of real estate as collateral enables firms and households to realise part of their wealth in real estate to enhance investment or consumption. The **weakness** is that in times of recession in the property market, this is not possible so that investment and consumption are depressed. At times when an economy is overheating, the realisation of wealth from real estate can add to inflationary and balance of payments pressures. Governments therefore need to monitor the real estate markets and, where necessary, take corrective action where their behaviour may undermine the macroeconomic situation. The relationship between the strength of a real estate market and the health of a country's financial sector can be most dramatically illustrated by looking at behaviour in real estate markets in times of banking and economic crises. (Bertaud, 1999, Keith et al 2000, Lea, 1999)

10. The problem of transitional countries lies in the separation of the housing sector from the economy. The countries in transition could not use the potential economic advantages of the housing sector. The housing sector could contribute to the macroeconomic recovery, but at the same time without macroeconomic stability no efficient housing system can be built.

### **1. Macroeconomic background: GDP, inflation and unemployment**

11. Macroeconomic stability is an essential part of the reform of the housing sector. The region has faced huge difficulties, as summarized below:

“Apart from being adversely affected by incoherent implementation of the reform agenda, the transition of the SEE countries has been hindered by persistent regional instability and a succession of wars, conflicts, embargoes and trade sanctions. The transformation process in the region has been also set back by a series of exogenous shocks that repeatedly shattered local economies given their inherent vulnerability to external disturbances. Though an unfortunate coincidence, it impeded the SEE countries taking grip of important structural and institutional issues that would have facilitated the establishment of the required conditions for higher and sustainable economic growth. While the commitment to macroeconomic stability appears to have taken recently hold in south-eastern Europe, the sluggish pace of reforms during the course of transition has left the economies of the region with mostly precarious public finances, generally weak institutional settings and rather difficult business environment mired by excessive bureaucracy, red tape and corruption.” (SEE, Online, Macroeconomic overview)

12. The overall macroeconomic figures showed a significant improvement, but due to the inherent instability in the sub-region of Albania, Serbia and Macedonia there are grave difficulties to cope with. In Macedonia, for example, 30 % of the country's territory was endangered by the war in 2001, according to the experts. The number of refugees in Serbia was estimated at 350-800 thousand in 2000. The political stability of the region is quite volatile.

13. In our study three parts of the region should be differentiated: Croatia (8 % of the population), Bulgaria and Romania (56 % of the population), and Albania, Bosnia-Herzegovina, Macedonia and Yugoslavia (36 % of the population). They are in different stages of development, and the degree of instability varies, too. Croatia (one of the most developed parts of the former Yugoslavia) has a GDP very close to the Visegrad Countries (4,179 USD per capita), the other countries of the region are around 50 % of that level. The poorest countries are Albania and Bosnia-Herzegovina, with a GDP around 1,500 USD.

**Table 1 Basic indicators**

	GDP per capita (USD), in 2000	Population (in million person), in 2000
Albania	1530	3,4
Bosnia	1581	3,8
Bulgaria	1500	7,8
Croatia	4255	4,3
Macedonia	1848	2,0
Romania	1640	22,4
Serbia	1397	11,2

Source: Croatia Report, SEE ONLINE

The GDP changes indicate the slow process of stabilization, but the region has not reached the pre-transition period. (Only Albania has reached the pre-transition level, but they started from a very low level.) The GDP growth has been varied in the last years depending more on the external factors than on the domestic demand. The rising GDP figures can be explained by the export-oriented industrial sector more than by the domestic market.

The inflation was number one enemy of the economic restructuring. In the second part of the 90's only Romania and Serbia could not manage their inflation, in the other countries the monetary policy cut the inflation figures. Low inflation seems to be a condition for building up a new housing financial system.

**Table 2 Inflation (% change):- annual average**

	1996	1997	1998	1999	2000	2001
Albania	17,4	42,1	8,7	-1	4,2	...
Bosnia	3,2	12,2	2,2	-0,4	3,4	...
Bulgaria	311	578	1	6,2	11,4	9,4
Croatia	3,4	3,8	5,4	4,4	7,4	4,5
Macedonia	0,2	3,2	-2,4	2,6	6,1	1,2
Romania	56,9	151,4	40,6	54,8	40,7	25
Serbia	59,9	10,3	45,7	54	113,5	30-35

Source: SEE ONLINE

There are countries with an unemployment rate higher than 25 % of the workforce, which indicates a very unstable economic situation. The high unemployment rate and the lack of the efficient safety net mean that the household sector has been facing a hardship. At the same time, it is important to note that low unemployment rate could be a sign of the slow restructuring. It is natural that in the period of the restructuring of the economy, unemployment increases, and at the later stage of adjustment process it will be stabilized. It is very difficult to judge from these indicators whether the economy has recovered. The misinterpretation of the performance of the Czech and Albanian economy in the beginning of the 1990s is a good illustration of this point.

**Table 3 Unemployment rate (% of workforce, e.o.p.)**

	1996	1997	1998	1999	2000	2001
Albania	12,3	14,9	17,7	18,2	16,9	...
Bosnia	n.a.	39	38,7	39	39,4	...
Bulgaria	12,52	13,69	12,17	15,97	17,86	17,11
Croatia	15,9	17,6	18,6	20,8	22,6	22
Macedonia	31,9	36	34,5	32,4	32,2	31,8
Romania	6,6	8,9	10,4	11,8	10,5	9,3
Serbia	26,1	25,6	27,2	27,4	28,8	30,1

Source: SEE ONLINE

14. The macroeconomic changes had a clear effect on three areas important from the point of view of the housing sector: housing subsidies, demand for housing and informal economy.

The housing policy in the transition countries is facing fiscal constraints. As a consequence of the macroeconomic policy, the government should cut the budget deficit. It is not only politics and the legacy of the housing system which are responsible for maintaining the subsidy system, but the ethnic conflicts and wars also raise the need for public housing.

The transition recession has led to the general decrease in the demand for housing investment, and a cautious saving and investment policy of the household sector, and increasing income inequality.

The informal economy is one of the most important constraints for the creation of the efficient housing finance system. The size of the informal economy is related to the transition recession. According to the research on this area the size of the informal economy is related to the macroeconomic development. With the decline of the GDP, the size of the informal economy is increasing, and with the economic growth it is declining. (Eilat, Yair and Zinnes, Clifford, 2000)

The size of the informal sector is estimated from 25% to 40% of their GDP (SEE online, 2001)

“The size of the unofficial economy in the Republic of Croatia was probably at least 25% of GDP in 1995. Two periods can be clearly distinguished between 1990 and 1996. During the first period up to 1993, all available data indicate that the size of the unofficial economy increased in relation to GDP. The second period began in 1994 and it is not possible to make a final judgement because despite the fact that a majority of indicators suggest a fall, some particularly important indicators point to an increase in the size of the unofficial economy. The calculated size of the unofficial economy in relation to GDP (25%) is large and will probably remain so in the foreseeable future because the inherited tradition, the transition with intensified sectoral and institutional restructuring, the large state influence in the economy, especially in privatisation along with the tax pressure, the recovery of growth and new enterprise, only support the unofficial economy.” (Ivo Bićanić, Katarina Ott, 1999)

15. The experience of high-growth economies in emerging market economies does strongly suggest that higher saving and investment ratios are key to successful economic development in South-Eastern Europe

“However, not all components of saving can be expected to rise markedly from current levels. At around 7% of GDP, foreign saving is stretched to the limit and higher FDI inflows are required only to change the composition of capital inflows rather than to increase them. Raising domestic saving is also associated with limitations. Weak government finances and the need to reduce tax rates further means that the scope for much higher government saving is limited. At the same time, high unemployment rates and low income levels limit the scope for increased household savings, at least in the short term. Macroeconomic uncertainty and the absence of functioning financial intermediation also limits the scope for channeling household saving to corporate investment. Weak property rights and weak accounting standards make it nearly impossible to assess credit risk, which is a key factor behind the region-wide lack of effective financial intermediation. The best means of raising private saving and investment levels in this environment is to raise corporate profitability. Corporate saving -- the internal financing of corporate investment from retained earnings overcomes the problem of low household saving rates, dysfunctional financial intermediation and lack of credit risk information”. (Hurst and Uppenberg, 2000)

## **2. Institutional settings**

16. The housing system has changed and new actors have appeared on the scene, the old ones are changing their roles. Transition in the housing sector means radical change in the behavior of typical housing sector actors in their norms, interest, and attitude. The restructuring process takes time.

### **2.1. Central government**

17. The housing policy in the Balkan region has become a secondary issue of the first stage of the transition. The same process took place in the Visegrad countries. The old housing policy ceased to work. The privatization of the housing stock, the restructured construction industry, the fiscal stress on governments, and the changing role of the banking sector made it impossible to continue the old housing policy. There were attempts to introduce new elements in the housing policy. Donor programs helped to set up new institutions and special government programs were started which have had an effect on the housing market, but have not yet led to real institutional changes.

18. The nature of housing policy has changed in the transition. In the first part of the 1990s the general tendency was that the housing policy ceased to exist because the state construction industry was ruined and the public stock of housing has been privatized. The public administration has not had the capacity to make housing policy fit to the changed environment. Most of the programs were fragmented without a clear understanding of the processes. The decision-makers lack the basic information, which is inevitable for intervention in the housing sector. Most of the programs (if they existed at all) were to allocate some of the sources without the capacity to analyze the impact of the program. This is one of the main constraints for formulation of a housing policy. The housing policy concepts (if they exist in Croatia, Macedonia, Romania, Bulgaria, etc.) use the concept and approaches of the planned economy, and think of the housing needs, natural conditions, etc. not in terms of effective demand, prices, transaction cost, market efficiency, etc. The studies and reports prepared by the donor agencies give insights for the housing sectors, but are not incorporated into the everyday housing policy by the housing administration, and remain just a sporadic phenomenon.

19. The responsibility of housing policy is typically given to the ministries which are responsible for the public infrastructure (public works, construction, etc.) The need for coordination among the departments dealing with the different aspects of the housing sector presents a more complicated task for the public administration. Typically the financial ministries have the decisive role in housing policy to determine the resources of the sector. As in almost every country of the region the fiscal pressure on the budget forces the government to decrease or/and keep the resources at a low level, which again makes it almost impossible to introduce changes in the approach of the housing policy. The possibility of the donor aid programs has not been used for promoting basic reforms, as the programs are targeting the urgent housing needs and do not have resources to introduce basic changes in administration and project management. The housing policy documents are promising to define the basic principles. However, the "housing ministries" are typically weak ministries and are outside of the processes of the basic restructuring.

In **Albania** within the Ministry of Public Works and Transport, the Department of Housing is responsible for the preparation of housing policy. The law provides the framework for the housing policy, but the reality is far from the expectations of the law. The huge work that the housing sector has to deal with is not supported by the necessary staff, organization and institutions. The Housing Department is a small one composed of two experts and the Director. There is no other institution or organization dealing with housing research, studies, data collection, etc.. Within the MPWT the Department of Urban Planning is responsible for the preparation of the urban development policy and controls the planning all over the territory. There are no links or collaboration between the Housing and Urban Departments. (Network, 2001)

In **Romania** the Ministry of Public Works, Transports and Housing is responsible for housing through the National Housing Agency. The National Housing Agency was set up in 1999. This is an off-budget government institution designed to manage government subsidized housing programs. In the National Strategy for Housing for 2001-2004 the government housing policy aimed at (1) mitigating the ratio between the market price of housing and the average family income; (2) facilitating the access to the market for specific categories, especially young individuals and families; (3) Providing incentives for private investment in housing; (4) Enhancing the role of the National Housing Agency as a developer and a loan funding institution, the NHA becoming also instrumental in developing a functional mortgage market. But funding the program is a question of politics and budgetary allocation. (Network, 2001)

In **Croatia** the Ministry of Public Works, Reconstruction and Construction is responsible for the housing policy, and there are three departments operating in the system of ministries which are dealing with different aspects of housing policy implementation. (1) Department for Housing, Building and Housing Construction, (2) Department for Reconstruction: (3) Department for Displaced and Dislocated Persons. (Network, 2001)

In **Serbia**, housing responsibility was given to the Ministry of Construction with a task to prepare programmes, organize and coordinate construction, sale and buying of flats and office space and of other buildings important for the Republic of Serbia, as needed by the state authorities. (Network, 2001)

In **Macedonia**, Ministry of Transport and Communication is responsible for housing, and the Public Enterprise for Housing is responsible for the execution of the government program. (Network, 2001)

In **Bulgaria**, The Ministry of Finance and the Ministry of Regional Development and Public Works have issued an order for the collection and spending of resources from the Housing Construction Fund to the municipalities. This fund has been created and the resources in it are used—when available—most of all, for the construction and design of municipal housing for rental purposes for citizens in low-income brackets and ones subjected to a housing shortage.(Network, 2001)

## 2.2. Local Government

20. Decentralization is one of the directions of restructuring the public sector in transition countries. Housing is typically a responsibility, which should be shared between the central and sub-national governments, and the lack of the cooperation causes a lot of conflicts in the housing sectors. Decentralization has been much slower than in the Visegrad countries, the reason for it is closely related to ethnic conflict and to the political views according to which decentralization could lead to weaker public administration. Some of the donor agencies share this view as well.

In **Albania** Local Governments are responsible for the homelessness issue, land development and building permission<sup>2</sup>, and implementing building regulations. However, the formal responsibility given by the law has not been supported by the actual possibilities of local governments in terms of the capacity, incentives and financial resources. Albania's government is highly centralized with financial resources and powers concentrated at the national level. Only six percent of the national budget finds its way to local governments. Mayors and other local leaders complain that they lack the funds and legislative authority to tackle critical local issues such as economic development and infrastructure improvement. The government, however, has begun the process of devolving powers to local governments. (Network, 2001)

In **Serbia** The municipal assembly, and the town, by their decision stipulate that a portion of wage fund tax shall be channeled and dedicated to solidarity housing scheme in the amount of 0.3% to 1% of the wage fund tax. This means that solidarity funds shall be continuously earmarked and dedicated to solidarity housing schemes. The municipal administration and/or the town administration shall be responsible for the distribution of flats, namely the conditions under which such flats shall be sold or received for use. In regulating the relations associated with the use of such solidarity funds, the municipal assembly, and/or the town shall equitably treat all the subjects that will be earmarking funds in its territory. (Network, 2001)

## 2.3. Government housing agencies

21. New agencies, the national housing agencies, appeared in the countries of transition with the attempt of providing a "public-private partnership". In Albania, Croatia, Romania etc. the government set up the agencies with the aim to channel donor assistance to the country. These state agencies (national agencies for housing) took over the role of the developers using state budget resources or donor aid money. They were not real market actors, and served to solve urgent housing problems and not to devise long-term housing policy objectives. There was an intention to turn these agencies into market actors like Fannie Mai at the later stage of the development. (For example, National Housing Agency in Romania). Their role could be questioned from the long-term housing policy perspective, as they could crowd out the private sector both in construction and finance.

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<sup>2</sup> For plots less than 0,5ha

In **Albania** the central government through NHA has built almost 10,372 apartments all over the country. The selling price of these apartments is 120-150 USD/m<sup>2</sup> with a tendency of increasing. When NHA is beginning a new construction, it is signing a pre-contract with the future buyer of the apartment. In this phase, the pre-contracted person is requested to pay 300-400USD. In this amount is included a 4% of the construction costs for the operational costs which is used for generating the money for NHA (salaries, maintenance of the NHA building, etc.). NHA sells the apartments to the homeless families that are recorded in the lists of L.G., with contract (i) for lump-sum payment, applying 30% of discount. In this case, the difference is paid by the Government. (ii) Contracts of loan, according to which the citizen pays the amount at equal monthly rates, calculated according to the yearly obligation, but not more than 20% of the salary. The loan's period and interests depend on the category of the family; for the homeless families included in the legislation the loan period is 25 years and the interest is equal to zero. The interest of the loan that NHA is applying according to the legal framework is uneconomic taking into account that the inflation rate is about 20%. (Network, 2001)

In **Serbia**, the Social and Affordable Housing Fund is planned to manage the accommodation program implementation. The fund will be established by the Government of the Republic of Serbia. The Managing Board will be constituted of representatives of the Ministry for Social Welfare, Ministry of Finances, Ministry of Urbanism and Construction, Ministry for Economic Relations with foreign countries, the commissariat for refugees and from time to time and temporarily of big donors, a total of 1+8 members. The Government will constitute the Supervisory Board of big donors' representatives (if any). The Supervisory board will periodically inspect the operations of the Fund. The Fund will implement a social and subsidised housing policy pursuant to the general social welfare policy in the country. It will establish mechanisms for the implementation of programs and individual projects, prepare and distribute documents (programs, preliminary design documentation, contractual documents), establish credit mechanisms, manage funds, collect funds from repayment of the loans granted, budget or donations, train staff for implementation and for the control of it and keep the founders and donors informed. The Fund will operate in harmony with the state housing policy. The initial capital in the Fund will consist of donations. An additional source could be a loan to be taken by the state from international financial institutions or the budget. Another kind of support would be the capital in the hands of the refugees, which could become part of the initial funds when deposited for the purpose of getting loans. Receipts from long-term loan repayment can be expected in the third year of operation only. In the meantime the Fund capital shall have to be replenished in order to raise the program efficiency. The Fund operations would be serviced by commercial banks and the banking sector would thus gradually elaborate their own long-term loan models for housing purposes. (Network, 2001)

#### **2.4. State enterprises: end of the old system**

22. The state enterprises used to play a decisive role in the pre-transitional period, e.g. in Yugoslavia, where the solidarity housing fund was a significant source of the housing finance. The role of the state enterprises as housing developers for their employees ceased to exist in most of the countries.

In **Albania**, the public enterprises that make profit have used their yearly profits for housing their employees. These enterprises, such as Petroleum Institute of Fier, Institute of Insurance, General Directorate of Durres Harbour, etc. have built some 6-800 apartments. It is presumed that their activity would be more limited in the future.

#### **2.5. New actors: developers, construction companies and real estate agencies**

23. In the pre-transition period the housing construction “industry” represented a dual system: (1) the big state owned construction companies typically building prefabricated housing units, and (2) the “self help” sector, where households organized the construction using the help of “relatives and friends” and/or buying services on the “black” market. Privatization has helped to develop the private sector in the real estate market as both foreign and local enterprises stepped in.

24. In the housing finance system these new actors create a huge potential demand for credit instrument. The expansion of this sector depends very much on the legality of their operation, which is fundamental for the increasing creditworthiness of these entrepreneurs.

#### **2.6. Condominium, housing associations**

25. The new actors of the urban housing system are the condominiums, which needed new legal background to act as real representatives of the new owners. The observers and analysts argue that privatisation has resulted in quasi-owners who do not have the attitude and financial means of the real owners. The new owner and their representatives had to face a new market of housing services, which in most of the countries were in decline. The level of housing related services declined because of the inflexibility of the service providers, decrease of the financial resources of the sector, both private and public, owing to severe cuts in the central and local subsidies, and because of the increase of costs, and the lack of “efficient owners”. As a result of these processes not only the public services (the water and energy services, district heating, garbage collection and waste management) have deteriorated, but the normal maintenance of the housing stock has also accumulated a huge backlog.

**In Albania.** The reality brought in evidence many weaknesses of the process of privatization. Although the law "On condominium" has been approved in 1993 and later it became part of the Civil Code, it was never put into practice. The privatization took place in a record time limit, and there was virtually no time for putting into place all the recommendations of the legal framework on the responsibilities for property management in condominiums. There are only individual repairs inside the apartments, but almost no maintenance for the common areas. The establishment of the condominium associations is left to the families and if the families don't agree they may go to the court to solve the problem. The court, however, has not solved any problems of maintenance or improvements in the condominiums. (Network, 2001)

**Croatia** The non-profit housing associations in the developed countries, originally acting as housing co-operatives, have a long tradition behind them and are now indispensable agents in addressing the housing problems. Indeed, the housing co-operatives are one of the most suitable forms of housing privatisation and housing provision to homebuyers. As organisations, the housing co-operatives have gained in importance in all countries in transition. Over a certain period of time the housing co-operatives played an important role in Croatia's housing policy. The Constitutional Court of the Republic of Croatia decided to repeal the Housing Co-operatives Act as of 1 October 2000. At the request of the Union of Croatian Housing Co-operatives, however, the enforcement of this decision was deferred. General Cooperative Law is subject to the housing cooperatives activity. Over the past period the housing policy was neglected in Croatia, so the repealed Housing Co-operatives Act was never harmonised with the Constitution of the Republic of Croatia. The Housing Co-operatives Act should be passed as soon as possible, in which the housing co-operatives will be defined as non-profit organisations like those in the developed countries, able to play an important role in Croatia's housing policy. (Network, 2001)

26. The condominiums represent a huge demand for housing finance, because of the deferred maintenance and poor construction. The present legal regulation is very ineffective to provide legal guarantees for the loan providers. The housing condominiums have low borrowing capacity, partly because their decision-making structure is limited, and partly because they do not own tangible collateral. A new solution could be developed to change these constraints. (Buckley, 2001)

In **Bulgaria**, the majority of housing was formally cooperative in nature, privatizing it meant simply terminating many of the resale restrictions. Instead of a coop resident being allowed to sell the apartment only at a regulated price to another worker at the same factory, the owner could now sell it to anyone (possibly subject to board approval) at a deregulated price. As a result, coops were falling apart because people who were now owners in fact as well as by law couldn't afford upkeep and repairs, and the former support system (including factories) no longer helped with maintenance. Lack of available financing might be a factor in the deterioration. Coop decisions are a public choice problem. If some coop members were cash hoarders and some were cash-constrained, the inability to finance repairs might prevent a majority from voting for cost-effective repairs. (Network, 2001)

### 3. Banking sector reforms

27. The banking systems in the transition economies are not very well developed compared with typical market economies with similar level of per capita income. (EBRD, 1999) In the first years, countries of the region set up autonomous central banks, tried to introduce new macroeconomic monetary and financial policy reforms concerned with building the core financial infrastructure: laws, regulations, supervising, accounting and payments systems. (Renaud, 1995).

**Table 4 Descriptive statistics of the banking sector, end-1999**

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	FR Yugoslavia	FYR Macedonia	Romania
Number of banks	13	62	27	40	81	23	34
Of which majority foreign owned	8	3	14	13	0	5	19
Total bank assets (US\$ billion)	1,8	3,1	4,2	10,6	11 (official exchange rate)	1,2	10
Assets of top five banks (% of total bank assets)	87	na	63	62	60	71	67
% of bad loans (total loans)	51	na	12	10,3	40-90	43	52,2
% of state assets (total bank assets)	81,6	77	48,9	39,6	>80	23,2	50,3
Domestic credit (% of GDP)	45,3	45	18,6	39,2	19,3	22,2	19,4
Credit to enterprises (% of GDP)	3,6	3,6	14,6	22	19	11,3	10,5
Total bank deposits (% of GDP)	41,9	21,5	21,7	30	27	16,7	22,4
Equity (% of total assets)	6,6	na	na	11,2	<0	20,7	21,4
Required capital adequacy ratio	12	8	12	10	8	8	12

Source: Pissarides, 2001

28. Privatisation of the banking systems and the establishment of private banks have taken place at varying rates in different transition economies. Liquidity problems and bad debts have been problematic in the region.

Problems in the banking system in **Bulgaria** have had adverse effects on the development of the mortgage market. The history of problems in the banking system has often resulted in very conservative lending norms. The Bulgarian banking sector has been undergoing significant institutional reforms since the 1996-97 banking sector crisis. To reverse a high rate of inflation and a shrinking economy, Bulgaria established a currency board-like system on 1 July 1997, based on an exchange rate of 1,000 leva = DM1. Since then, the Bulgarian economy has quickly recovered. Introduction of the CBA in mid 1997 speeded up bank privatization. More than 80 % of the banks' assets are privately owned and more than 70 % of banks' assets are held or controlled by foreign banks

**Romania** introduced a two-tier banking system in 1990. This consisted of a central bank, the National Bank of Romania (NBR), and approximately 40 commercial banks, including 12 branches of foreign-owned banks. Confidence in the financial sector was upset by a number of highly visible financial upheavals involving mutual funds and savings accounts. By the end of 1998, state-owned banks still accounted for more than 70% of all banking activity. Many of these had large portfolios of non-performing loans. A number of major banks were privatized in 1998 and 1999, whilst two other major banks went into receivership. (Housing Profile, Romania, 2000)

The banking system in **Albania** is composed of National Banks and of joint venture with foreign Banks. The Central Bank status is attributed to the State Bank of Albania, for it issues currency, transacts government accounts. The Saving Bank was established in 1992, using the assets of the government insurance fund. The bank has increased its activity and opened offices all over the country. Deposit interest rates vary according to the type of the account. According to personal choice, for deposits in LEK the rate is changing according to the inflation. Last year the interest rate was 35-40% per annum, while deposits in USD return 5% per annum. There are some other banks parts of which are in joint venture with the government like the BANKA ITALO-SHQIPTARE; BANKA GREKE; BANKA ISLAMIKE; but they are not involved in the housing sector because of the very high interest rate that they have. Albania's rudimentary banking system is overseen by an independent central bank, the Bank of **Albania**. Banks do not play a central role in Albanian business. Most local businesses do not rely on bank financing to fund their enterprises. Business start-ups are funded by cash (often foreign remittances) supplied by family, friends and partners. Albanians, generally unfamiliar with banks and distrustful of financial institutions after the 1996-97 collapse of the pyramid schemes, are wary of depositing their savings in banks. An estimated 33 percent of the country's total money supply is outside the banking system. In addition to the central bank, there are 12 other banks in **Albania** The GOA is privatizing two state-owned banks, the national commercial bank and the savings bank.

The savings bank has the equivalent of approximately USD 1 billion in deposits and nearly 80 percent of all Albanian bank deposits. The remaining 10 banks are foreign-owned or joint ventures. In addition to these banks, two equity funds maintain offices in **Albania** and are looking for taking equity positions or make loans to local enterprises.

As stipulated in the Dayton Peace Accord, **Bosnia** established a currency board-like system linked to the German mark on 1 August 1997. Statistics of the performance of the Bosnian economy remain sketchy as a result of the damage caused by the civil war.

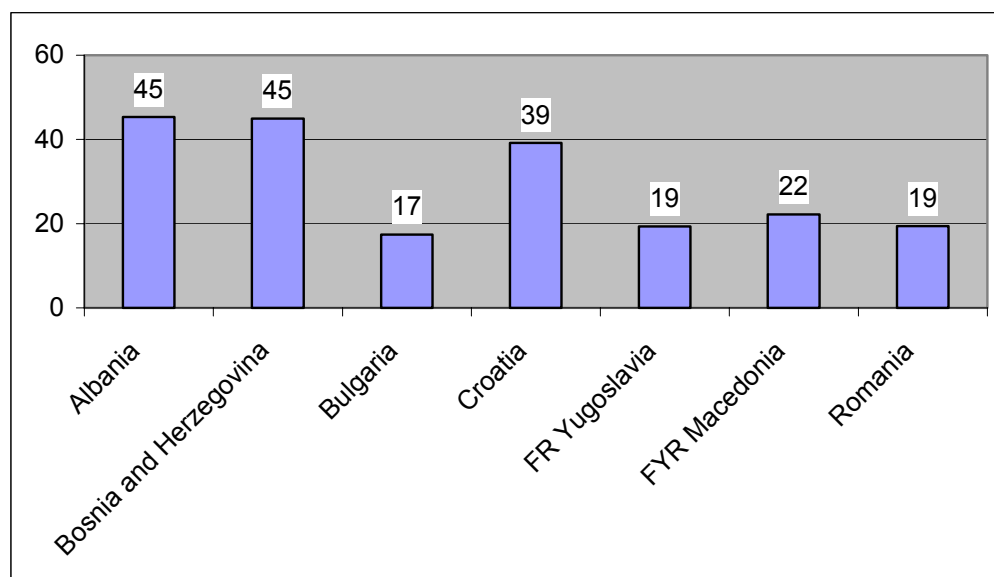
29. After the consolidation of the banking system, the domestic lendings decline. One aggregate measure of banking development is the ratio of domestic credit to GDP. According to the study of Fries and Taci (2001), transition economies in the region, except Albania, lie below the market economy benchmark for the ratio of total domestic credit to GDP. Moreover, there is no convergence (except Romania) toward the benchmark between 1994 and 1999 through an expansion of total domestic credit in excess of output growth.

**Table 5 The Ratio of Total Domestic Credit to GDP in Transition Economies and their Estimated Market Economy Benchmark Values (in per cent of GDP)**

	1994			1999		
	Ratio of Total Credit to GDP	Market Economy Benchmark	Distance from the Benchmark	Ratio of Total Credit to GDP	Market Economy Benchmark	Distance from the Benchmark
Croatia	31,6	48,6	17	39,2	57	17,8
Albania	51,3	34	-17,3	45,3	39,5	-5,8
Bulgaria	103,4	51,1	-52,3	18,6	51,5	32,9
FYR Macedonia	78,8	43,1	-35,7	22,2	45,2	22,9
Romania	11,1	48,1	37	19,4	49,7	30,2

Source: Fries and Taci, 2001

30. The most important general factors are (Ulgenerk, Zlauni, 2000): (1) the effects of banking crises, as the banks after the crises become more cautious making loans; (2) macroeconomic decline makes a lot of potential creditors uncreditworthy, and new customers do not have the trust in the banking sector; (3) lack of competition led to high real interest rate, making loans too expensive; (4) imperfect legal system makes the contract enforcement weak and the risks high. The low level of private sector lending has an effect on the potential of the mortgage markets as well. The housing sector and housing policy can contribute to the expanding domestic lending, but it is important not to lose the financial discipline of the market actors.



**Figure 1 Domestic credit / GDP, in per cent in 1999<sup>3</sup>**

31. The future stabilization in the non-banking financial sector would be important for funding the domestic lending. Insurance companies give a great potential for funding long-term loans.

#### **4. Legal issues: rule of law**

32. The legal environment of housing is a key issue of the transition. There are several areas of the law, which are relevant to housing finance (foreclosure, insecure title, condominium law, etc.) An efficient legal system not only provides the necessary conditions for the operation of the housing market, but at the same time makes it possible to transfer titles and makes loans at lower costs. The economic consequences are not transparent in the legal systems, which explains why politicians do not prefer the programs of legal restructuring. The experiences of the last ten years have taught us that the introduction of the new legal framework is crucial, but without an efficient enforcement system its effects are questionable. To introduce legal regulations which cannot be enforced could distort the existing legal system as well. It turned out that building up efficient enforcement procedures is more difficult than the creation of the new laws.

<sup>3</sup> Source: IMF (2000b) and EBRD, Pissadires, 2001

33. The lack of clarity in land rights, which increases transaction costs, adds to investment risk and increases the discount rate. The land registration is not just a legal, but a technical issue as well. The existence of the so called “building pyramid structures” are related to the improper land registration. (Tzveta, 2000)

As serious as these problems are, the people of Kosovo have no formal legal remedies allowing the regularization of **housing** and property transactions and relations. The **housing** and property sectors are currently almost unregulated and this must change if democracy and the rule of law are to prevail in the Province. While the local judiciary and municipal governments may eventually be able to provide some of the required solutions, their capacity appears as insufficient and the establishment of an ad hoc mechanism to deal with these issues is considered necessary. (UNEP/UNCHS, 1999)

Equally or more damaging to human settlements in **Kosovo** is the collapse of the administrative systems that make them function. The assessment of conditions in Kosovo indicates that issues such the administration of the housing sector and property transactions and ownership; property registries and cadastre; and municipal administration are at the core of the continuous deterioration of conditions in Kosovo. (UNEP/UNCHS, 1999)

**Croatia:** When the Law on Land-Registers and Law on Property and Other Actual Rights became active, law presumptions have been made for modernisation and reaffirmation of land-register as only and exclusive public registers on legal state of immovable. After the end of World War II by establishment of the public (state) property, the dualism of property has been created which has resulted in disordered state of land-register, huge number of unregistered immovable and actual rights of their bearers.

**Serbia:** The increased population movements have contributed to increased concerns regarding property rights. With neither the Housing and Property Directorate nor the civil justice system being able yet to deal with property disputes, the large number of returnees generally find themselves unable to legally access accommodation, or their return to existing accommodation causes secondary displacement of the previous inhabitants. No matter how harmful this phenomenon may be to the image of the industry, it certainly continues to exist. Of all building companies, no more than a hundred are engaged in fraud and are ruining the reputation of the industry.

34. Mortgage law reform is especially important to property market development because of its relationship to increasing mortgage lending by banks. Changes to the Civil Code and a Law on Court Procedures are needed to clarify and strengthen enforcement and execution procedures in the case of foreclosure. Foreclosure should be accomplished without a court proceeding, restrictions on eviction have to be eased and changes in priorities in order of payment from proceeds of execution need to improve the position of mortgage lenders. Residential and commercial mortgage lending is increasing throughout the region. While other forms of security, such as third-party guarantees, are still required in many cases, incidence of foreclosure is increasing, if only as a last resort, and the expedited legal procedures are regarded as an effective deterrent to default. As economies and legal frameworks improve, more banks are becoming interested in mortgage lending, particularly those with foreign bank partners.

The old type banks of the post-socialist countries do not have the capacity to tackle the arrears issue, therefore arrears have accumulated and created a huge problem.

**Bulgarian** law recognizes contracted and legal mortgages. The first is a mortgage, which arises upon the signing of a mortgage contract executed in the form of a deed. Both the one who owes the debt and a third party may use an object as collateral for the creditor. The deed contains certain data such as information about the credit recipient, the amount of the loan and especially information about the property, which serves as collateral. In certain cases where the state is the creditor, the right to legal mortgage is also instituted. Recording is an important element of the mortgage. A mortgage is instituted through its recording. This provides for the mortgage to become known. This strengthens the mortgage regime and provides protection to third parties acting in good faith. Recording is done in the notary registers, ex-officio by the recording judge for the area where the property is located. Recording is done in an established order. Mortgages are struck at the request and with the consent of the creditor and also pursuant to court rulings. Striking may also occur at the request of the buyer of the property who has purchased it at public auction. Mainly Law on Contracts and Obligations, the Notaries and Notary Business Act, the Regulation on Recording, the Civil Procedures Code, etc regulate the mortgage regime. (Tzveta et al, 2000)

35. Standards of construction were often poor giving rise to problems of organisation, management, maintenance and affordability. The illegal construction (traditionally accepted in former Yugoslavia, and a new phenomenon in Albania) makes it more difficult to set up a proper institutional framework for the housing finance system.

In **Serbia**, in the course of 1998, 5,320 approvals for construction were issued. In March 1999 the Law on Physical Planning and urban planning was changed to simplify the building permit procedures. As a result, 12,000 decisions for construction were issued in 1999. (Network, 2001)

In **Romania**, the State Inspectorate for Building and Urban Planning, MLPTL, admitted it black market or illegal construction 20%, according to a sample survey in 1993 and according to an expert estimate 10% since 1994. (UN, 2001)

**Albania** is an extreme case for illegal activity. In Albania as a consequence of the introduction of democracy and the possibility to choose one's living place, some of the cities were affected by a big influx of migration. This phenomenon was more evident in Tirana. The Government was unprepared and unable to provide either a house, or a serviced area where they could be established. No employment opportunities were offered to them.

"In Albania zoning has gone out the window, needless to say -- exacerbated by informal settling on the urban fringe, where people are putting up houses without allowing for the installation of infrastructure. This "informal" energy was not tempered by the social and political chaos of the past year; it probably even increased as what was left of governmental land use institutions basically closed down. What they have, then, is a very active "market," an important construction sector, and a city that cannot cope with infrastructure

maintenance, let alone expansion. All the while, the country is trying to figure out what is the proper role of government and what new institutions are needed to deal with the private property type economy while properly managing public spaces.“ (J. David Stanfield, World Bank Conference on land economy, 1999)

In **Bosnia**, the unregulated market is generally comprised of low-cost construction and low-value transactions; most participants are local citizens with limited opportunities for financing or legal protections. Construction permits are often not obtained and land use regulations not observed; transactions are not likely to be registered. (UI, 2001)

36. Corruption is an important constraint for the development; no public administration can be improved without controlling corruption in public affairs. According to Transparency International ([www.transparency.org](http://www.transparency.org)), countries in the Balkan have an average score of 2,81, much lower than the Visegrad countries (4,56), and slightly higher than the FSU countries (2, 52).<sup>4</sup> One of the key elements of the sound financial markets is trust in the legal system; corruption undermines trust.

**Table 6 Transparency Indicator for 1999**

Rank	Country	Score
63	Bulgaria	3,3
63	Macedonia	3,3
63	Romania	3,3
74	Croatia	2,7
84	Albania	2,3
90	Yugoslavia	2

Source: [www.transparency.org](http://www.transparency.org)

In **Serbia** the Commission has detected the following irregularities in the period 1996-2001: (1) 9.5 million dinars were provided by the Serbian government budget over the five-year period, and 240 million dinars were spent on flats, thereby constituting a serious violation of the Budget Law; (2) a total of 287 flats ranging in size from 30-180m<sup>2</sup> were allocated through the government's housing commission to personnel in the Ministry of Justice and the judiciary; (3) 337 loans were granted through the Ministry of Justice; (4) Eleven individuals were established to have been allocated more than one flat, nine persons obtained both flats and loans, while 32 persons were granted more than one loan; (5) 52 cases are under investigation at the moment, and additional data are expected from municipal offices, the Belgrade City Assembly and the Agency for City Building Land and Development of Belgrade. (UNHABITAT, 1999)

<sup>4</sup> The maximum score was 10 (Dania), the minimum 1,5 (Camerun).

In **Albania**, the critical issue is public order and stability. After the collapse of the pyramid schemes in 1997, Albania descended into anarchy with citizens looting weapon depots and destroying factories and businesses throughout the country. The country was again thrown into turmoil in September 1998, when political violence forced the prime minister to flee the country. Recently, however, the government of **Albania** has made significant progress in restoring public order throughout the country. Ongoing reform in the ministry of public order, strongly supported and assisted by the international community, has bolstered police effectiveness and increased police morale and visibility. Criminal activity has decreased in most parts of the country. In October 1999, the country experienced a peaceful transition of power, when PM Majko was replaced by his deputy, Ilir Meta. Other critical issues affecting business include endemic corruption in both government and business circles, the lack of bank financing and credit for businesses, and the inadequate transportation and energy infrastructures that inflate production and distribution costs. (New agency)

## C. Housing market

### 1. Demand for housing

37. The housing finance basics started with the evaluation of the factors influencing the demand for housing. The most important fundamentals on the demand side are the income, demography and preferences.

Demands for housing finance are based on the investment need in the economy. The effective demand depends on several factors (Diamond, 1998, Hegedüs-Várhegyi, 2000): tradition towards the loan, households portfolio decision based on expected financial advantages, saving attitude, future expected income, and insufficient understanding of loan instrument, etc.

The household income decreased in the region, which gives an explanation why the expectation of the "increasing demand" has not realized. The factors related to demography will be discussed. The preferences have changed, and the move from the housing estate (typical housing type of the socialist period) is substantial. But the purchasing power behind the changed preferences has not yet been realized.

Beyond the basics there are new elements determining the housing needs: refugee problem, deferred maintenance, the shortage caused by the decline in housing output, and the special need because of the impoverishment problem.

The housing problem of the region is a mixture of the quantity issues mainly influenced by the forced migration and the quality problem related to the changed preferences and the poor construction standards in the socialist period.

#### 1.1. Demographic trends

38. The demographic trends and the number of the housing units indicate that in most of the countries in the region there is no quantity shortage. (See Hegedüs, Mayo, Tosics, 1997, Hegedüs-Tosics, 2001)

**Albania** seems to be a special case. The average household size is very high (4,2), the number of households has increased by 8 % in the 90s, and 15 % of the households share their home with their parents. (*INSTAT, 2001*)

In **Bulgaria**, the negative tendency towards total decrease affects not only the city, but the village population as well. Compared to 1995, the city population decreased by 2% and the village population by 3.1%. At the same time, the city/village population ratio remained almost unchanged during the last decade - in 1999 68.1% of the population have lived in the Bulgarian cities. The average age of the population increases –from 37,5 in 1990 to 38,9 in 1995 and 39,2 in 1999. A positive sign is that last year the birth rate has increased slightly to 8.8 %. Projections for the next years' birth rate and natural increase values can be made easily if we have in mind the two "baby booms" in Bulgaria - one after World War II and then one in the 70's.

That is why the natural mortality rate is expected to remain high in the next years and the birth rate will go slightly up. (Tzveta, et all, 2000)

## **1.2. Housing stock: war damages, deferred maintenance and accumulated needs**

39. The war, the deferred maintenance and the needs not satisfied in the last ten years add up to a huge investment need.

In **Bulgaria**, the number of housing unit which is morally or physically obsolete is roughly 180,000; and number of housing that lacks basic utility elements is 12-13,000. (Report for the network, 2000)

According to estimates are there have been some 2.2 million displaced persons in **Bosnia-Herzegovina** with rights affecting over 500,000 properties. A strong regulatory and institutional framework is necessary not only to help these persons avail themselves of their rights, but also to handle the many thousands of transactions that will ensue when they are able to do so. (UI, 2000)

In **Kosovo**, 120,000 houses were damaged in the 29 municipalities of the Province. Estimates for Serbia put the damaged units in the range of 50,000. The levels of destruction vary considerably from area to area. It is estimated that over 40,000 units are beyond repair and need complete replacement. It is estimated that the damages to housing amount to EUR1.1 billion. The cost of the damages to basic infrastructure (education, health, energy and water) is estimated at EUR40 million. (UNEP/UNCHS, 1999) In 1999 380 thousand nationals from Kosovo, 7 % of total population of the Republic of Macedonia, went to Macedonia. 9 camps were settled providing shelter for 160,000 persons. (Habitat report).

In **Albania**, the housing stock is old and in poor condition, and the country has a housing deficit of approximately 45,000 units.

In **Croatia**, between 1995 and 1998 reconstruction of demolished housing cost was 1% of the GDP (Madzerevich and Sujster, 2000).

### **1.3. Migration and refugee problems**

40. As a consequence of the Balkan war, a huge problem of refugees and migration arose. Thus in the Balkan countries involved in the war, the problem of refugees dominates the housing problems.

**Serbia:** The refugees are accommodated: 5% in collective centers, 44% in rented flats, 30% with cousins and friends, 18% in their own abodes, and 3% in social institutions and other specific forms of accommodation. Conditionally, one average refugee family has 2.9 members. (1991 Population census.) The information for the territory of Serbia without the AP Kosovo and Metohija is taken from the Statistic Yearbook "Municipalities in Serbia 1999" of the Republic Bureau of Statistics. The refugee registration results, April 2001 show that an average family has 2.4 members, but this is considered to be an artificially fragmented family – for example, the young are in a rented flat and the old are in a collective center. Since according to the census 38,000 families already live in their own abodes, another 10,000 families are assumed to be able to solve their housing problems as part of the programs of collective centers abandonment, and about 15,000 families are expected to return to their native country, we get a number of 90,000 families that shall be covered by permanent accommodation programs.

### **1.4. Social needs**

41. Although there was no absolute shortage in housing, there was a significant need for more housing that was affordable for low-income groups. The low-income social groups will not be able to afford to finance home ownership, thus to support these groups by public housing will be needed. As a result of the extreme privatization policy no substantial public sector remained. The increased income differences and a huge unemployment make it impossible to create financial discipline for the sector.

Vulnerable households are dependent on the social welfare system, which does not receive sufficient public resources to grant adequate allowances (UNHCR April 2000 & August 2000). Large proportions of the displaced persons continue to illegally occupy houses or flats left behind by other displaced. A smaller group lives in collective centers. Housing shortages prevent the provision of alternative accommodation to most of them. The lack of accommodation is further aggravated by the repatriation of refugees who cannot return to their homes of origin, further adding to the problem of internal displacement (UNHCR 30 April 2001).

In **Bulgaria** about 300,000 dwellings are occupied by two or more families, over 130,000 units are with three and more occupants per room, about 54,000 with four and more (1992 Census) (Habitat Report, Bulgaria, 2000)

## 2. Supply of housing

42. Three types of investments can be differentiated: new construction, renewal/rehabilitations and second hand buying.

43. New construction is generally the first priority of the housing policy. The policy tries to give as much subsidy as possible. There is a debate among housing specialists about the efficiency of the new construction oriented housing policy (supply side subsidies). The important thing is that these elements of the housing sector are interrelated through the household decisions. In a system where the subsidies could cover just a fraction of the cost of the transaction, the decision of the household to renovate, move to a new house or to buy an existing one is crucial, and the subsidies are only one element among the factors household evaluate before the decision. Housing prices, location, taxation (tax avoidance, etc.) could be equally important. The reconstruction in the areas of the war-damage is of outstanding importance.

### 2.1. Tenure structure

44. As a result of the privatisation, a new tenure structure has arisen with the dominance of owner occupation. After the privatization housing is the main form of household wealth, and the huge share of household expenditures goes to the housing sector. As a consequence of the privatization<sup>5</sup> the public sector role has decreased below 10 % in the countries of the region.

**Romania:** Even under the centrally planned regime, private ownership of housing was relatively common. Since economic transition has been under way, housing is probably the sector that has seen the greatest degree of privatisation. Of about 7.5 million dwellings, only 347,000 remained in public ownership by the mid-1990s. The average size of apartments is large by the standards of the region, and overcrowding is not normally a problem. The main focus of the construction industry for the next few years is therefore expected to be refurbishment and modernisation of apartments, rather than increasing the housing stock. Where refurbishments are extensive, this will provide opportunities for incorporating thermal improvements. Securing loans against homes is virtually unknown in Romania, so housing sales tend to be cash-only. This also limits the possibilities for financing energy efficiency improvements. (Network, 2001)

**In Albania** almost 98% of the houses are privately owned. The houses built by the public sector are only meant for ownership tenure. There are no data on private rental market, even though it exists.

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<sup>5</sup> In Bulgaria, the share of the public sector was very low even before the transition, 7 % in 1990.

After the **Croatian** state was established, the situation in the housing sector was mostly marked by the process of privatisation of the so called "socially owned apartments" to the tenants with the tenancy right (similar to other transitional countries). According to the census of 1991 the total housing stock amounted to 1,772,945 units, out of which 1,575,644 units are in use. During the past decade, from the total of 393,242 apartments with the tenancy right, the tenants have bought about 312,000 apartments (79%), so that for the various categories of protected rental there remained only about 80,000 apartments.

45. The problem of the rental sector. A new private rental sector has emerged, but it is small and has been specialised for the high-income groups. The lack of the true rental sector is a constraint not only for the efficient housing finances, but for the mobility and the unemployment issue as well. In most countries there are no reliable data on the real share of the private rental stock, as a significant part of this stock is hidden in order to avoid taxation. Private renting is also uncommon due to traditionally very strong tenant protections, which serve as a deterrent to landlords, housing subsidies that tend to favor home-ownership, and a strong post-socialist preference for owning property.

In Bulgaria the private rental sector increased from 0.4 % to 1.6 % of the stock between 1990 and 1998.<sup>6</sup>

A rental market has also developed, although it is difficult to gauge its size. It is widely believed that much of the market is hidden because of tax evasion. One survey suggests that about 3% of households in Bucharest rent units from private owners<sup>7</sup>. Figures for other urban areas and rural areas are thought to be lower (according to the 1999 Institute for Quality of Life survey). An additional 1.8% of households are "rent-free tenants".<sup>8</sup> (UN, 2001)

## 2.2. Housing investment: new construction and reconstruction

46. Housing investment is an important factor in the macroeconomic restructuring. The countries with war damages have a huge need for reconstruction. There are very few reliable data about the investment in reconstruction, but the volume in terms of money could be the same as the new construction. The programs have been initiated and supported by donor agencies.

In **Serbia**: The Central Housing Committee met and discussed the development of the housing reconstruction activities and the future policy of the Department of Reconstruction post-2000. By October 11, 2000, a total of 15,500 houses are either underway for reconstruction or have been finished. It is envisaged that the target figure of 20,000 houses rebuilt by the 2001 may be reached. The Housing Directorate presented the CDF Policy Matrix on Housing (Comprehensive Development Framework), one document of the PRIB 2001–2003 (Public Reconstruction and Investment Programme).

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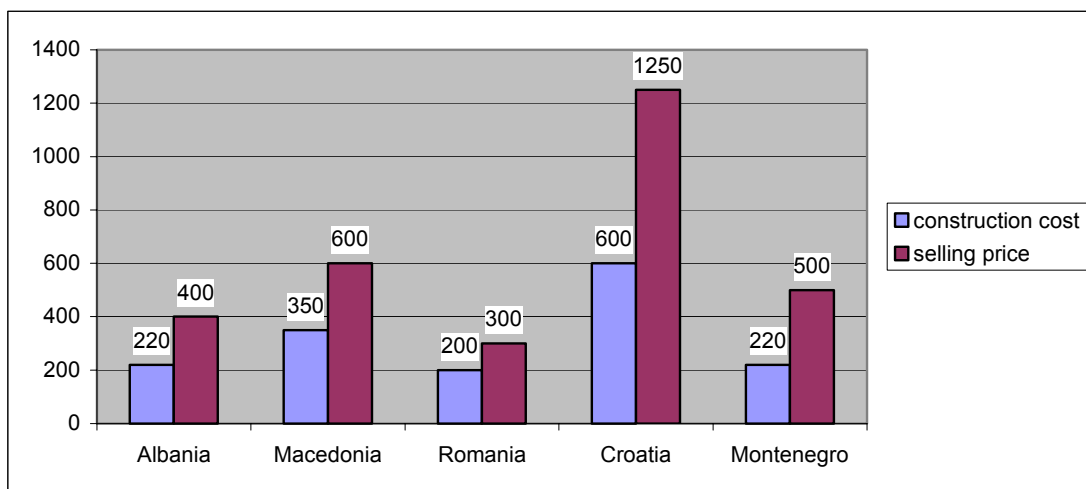
<sup>6</sup> Habitat Report, 2000

<sup>7</sup> The same figure is suggested for the countrywide share of private rentals in the UN/ECE- CHF Practical workshop on housing privatization, Cracow 1999.

<sup>8</sup> National Human Development Report, UNDP, Romania 1999, table 36.

The Housing Directorate proposes the further assistance of the most vulnerable families post-2000, particularly families with completely destroyed houses. The department of Reconstruction met with the European Agency for Reconstruction on the project proposal on housing for 2001. The number of houses is drastically reduced to 3,000. The proposal includes a loan pilot programme for the private housing market sector and support to the HPD (Housing and Property Directorate) for a branch office in Mitrovica, and a Housing property verification team for future housing reconstruction projects. The DOR stressed the outstanding remaining needs of housing reconstruction for the most vulnerable families. (Weekly Report on Pillar IV Activities, October 9-16, 2000)

47. Construction costs are high due to the use of old technology and materials to build **housing** units. Builders have not modified their construction methods to increase their productivity and gain efficiency in the past decades. Other costs include excessive taxes and land transfer fees. Those concerns, along with the question of legal enforcement of mortgages, have been discussed in great detail by others. The cost of the new construction is high in the region compared to the incomes.



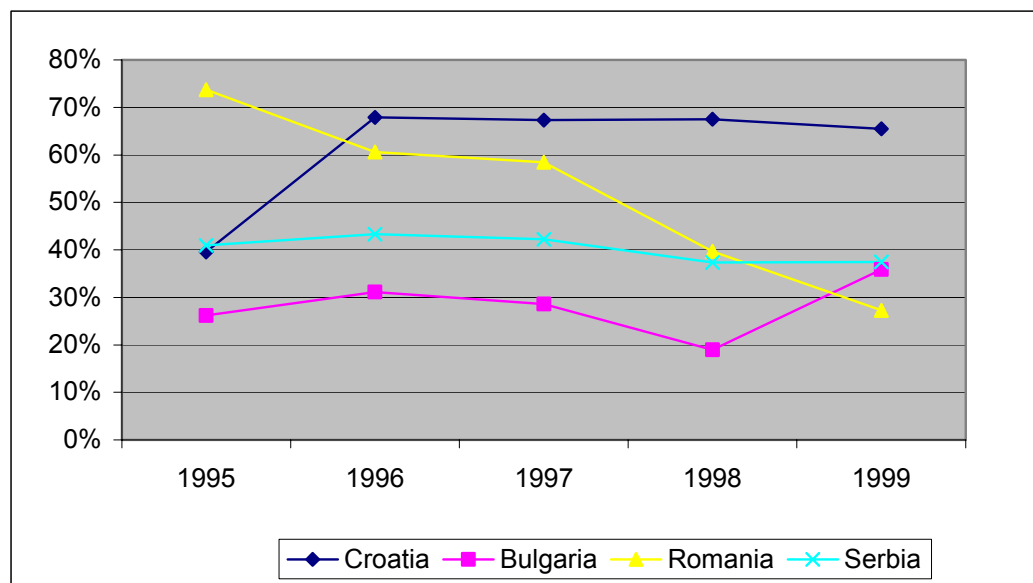
**Figure 2 Construction cost and selling price of a new unit USD/m<sup>2</sup> (based on expert estimates)**

48. The new construction has decreased all over the region. This is a consequence of the macroeconomic changes; despite the huge demand the household sector willingness and ability to invest is very low. To compare with the level of 1990, only Croatia has reached the 70 %, the other countries in the region are at 30-40 % level.

**Table 7 Total number of dwelling completed per 1 000 inhabitants**

Country	1990	1995	1997	1998
Bulgaria	2,9	0,8	0,9	0,6
Croatia	3,89	1,59	2,74	n.a.
Romania	2,09	1,58	1,33	1,32
Macedonia	5,0	2,3	2,1	1,6

Sources: UN/Habitat Statistics, Network 2001

**Figure 3. New construction 1995-1999 (1990=100)**

In **Albania** A residential building boom is transforming the face of Tirana, Durres and other large cities and offers opportunities for construction and related companies. The tourism sector also appears on the verge of significant growth with Albanians returning to seaside resorts in large numbers in summer 2000 for the first time since civil insurrections of 1997 - 1998. The agricultural sector is also expanding with increased fruit, vegetable and grain production in 2000. The new construction figures for Albania are contradictory, the building permission data indicate a low level of investment, but the statistics for 2000 gives a figure of 5.0 units per 1000 inhabitants. The new construction in **Bulgaria** is almost exclusively one-family houses, in **Romania** and **Croatia** the rate of flats is around 50 % in new construction.

49. The construction industry has been restructured. One of the most important consequences of these changes have been the introduction of building materials with higher quality standards, which contributed to the higher construction prices. The new housing is mixed in the region as "self-help" schemes use second quality materials.

In Macedonia: the construction cost is 1,157 DM/nm. 45 % goes to the infrastructure and 55 % goes to the building. Land tax is very high which is probably a factor discouraging the new investments.

Return of refugees and displaced persons remains the cornerstone of the EU's assistance programme to BiH. As part of its major effort to help people return to their homes of origin, the European Union has to date rebuilt more than 40,000 houses all over the country, with a clear emphasis on the regions where returns are most likely to happen. But repairing roofs is not enough for the people to come back: they need jobs, schools for their children, healthcare, social security... That is why reconstruction of houses goes hand in hand with rebuilding of health centres and schools and the revival of small businesses. The EU's privileged partners in this type of integrated return projects are non-governmental organisations (NGOs). But there are not enough reconstruction grants for all the affected Bosnian families. This is why the EU has set up a housing finance programme in collaboration with Bosnian commercial banks. Individuals can have access to loans to rebuild their house through this programme, which has a double objective: to improve housing supply, and at the same time establish a sustainable financing system for housing construction in BiH. In 1999 the nine partner banks participating in this housing loan project approved 1650 loans totaling 14.25 million Euro. The task is enormous: by the estimate of the U.N., some eight hundred ten thousand residents who fled during last year's war have returned to a province in which approximately two-thirds of the housing stock was destroyed or damaged beyond repair. Not an appealing base on which to rebuild a traumatized society.

Housing construction, with the priority placed on Kosovo: Rapid reconstruction of homes must be promoted through making emergency loans available to the returning population. That will create the foundation, at the same time, for the creation of small and medium-sized industries, especially in the construction and construction-materials industry. The majority of the new homes must be completed by September.

Significant features of this period are the fact that: (1) New construction shifted from urban to rural areas (the urban/rural ratio in 1990 was 85.4:14.6, and in 1999 35:65); (2) The basic amenity standards of new housing worsened (in 1998 only 33% of all new units were connected to sewerage systems compared with 89.7% in 1990; the trend for piped water connections was similar— from 91.4% in 1990 down to 43.2% in 1998). This last negative trend can be partially explained by the dominant share of new construction taking place in rural areas, where water-supply networks are insufficient and cesspools are traditional. Apart from addressing basic infrastructure supply, the above trends require a revision of building regulations and their application. (UN, 2001)

### 2.3. Second hand market

50. In urban areas, housing markets are active despite the absence of a mortgage market. Flats are routinely bought and sold and average prices are reported in the popular press (not necessarily accurately).

In Romania, the price difference between existing and newly constructed units has made newly constructed units unattractive to buyers. This is illustrated by the fact that nearly all of the 11,000 beneficiaries of a recent government-subsidized loan programme chose to purchase existing units rather than new ones. The decline in new housing construction has contributed to heavy job losses in the construction industry; the number of construction workers in 1999 (342,600) was only half of what it was a decade earlier.<sup>9</sup> (UN, 2001)

The number of residential sales rose from about 39,000 in 1990 to a peak of about 226,000 in 1993, before dropping to an annual rate of fewer than 180,000 by the mid-1990s. The 100,000 sales reported in 1999 were expected to be followed by even fewer in 2000: evidence of the continuing stagnation of housing markets after 1996. Most transactions involved the privatization of existing dwellings, or their resale, and not newly constructed units. For example, only about 36,000 new units were finished in 1995, yet there were approximately 170,000 transactions during that year (representing about 2% of the total stock)<sup>10</sup>. Therefore, notwithstanding the high level of private ownership, housing mobility is very low for most people. (UN, 2001)

51. In SEE countries the second homes are an important factor in the housing stock. In Bulgaria and Macedonia its share could be close to 10 % of the stock.<sup>11</sup>

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<sup>9</sup> UNECE Annual Bulletin of Housing and Building Statistics and National Commission for Statistics.

<sup>10</sup> The Prospects for Housing Finance in Romania, the Urban Institute report, Washington D.C. Dec. 2000.

<sup>11</sup> Of the total existing housing stock of 580.342 housing units with a space of 41.752.173m<sup>2</sup>, 61.450 or 11,2% are empty (Census 1994), that is one person owns several housing units. The empty housing units are mainly located in the capital, or weekend houses (villas), flats used for holidays in the tourist resorts. (Network, 2000, Macedonia)

## D. Affordability issue

Housing affordability is a key issue of housing finance. We should differentiate between affordability for the existing stock and the affordability for the access of housing.

### 1. Affordability of operation and maintenance of the housing stock

52. The transition and the war in the Balkan led to an impoverishment of the population. For example, according to a study, in Bulgaria 37 % of the population lived in poverty at the end of 1997 (World Bank, 1999), in Macedonia about 35 percent of the population is unemployed and 22 percent lives below the poverty line.<sup>12</sup> The decrease of the GDP and real income is accompanied with the increasing income inequalities.

53. The share of housing expenditures has increased in the households' outlays after the transition. The cost of the housing related services has increased in real terms, but quite unevenly: energy cost, building materials increased the most, while other – mostly domestically produced – services followed these tendencies with a delay. Countries followed different strategies in introducing cost recovery user charges in the housing related public services. The housing sector in most of the countries is far from the full cost recovery.

In **Romania** electricity prices remain well below cost-covering levels, especially in the residential sector. However, there is a strong commitment to address this problem in the immediate future. There have been three tariff adjustments in 1999 and, in the last two years household prices have risen by 105%, while industrial prices have fallen by 33%. Unfortunately, the steady weakening of the lej means that successive increases in household electricity tariffs have done little to close the gap with international prices. Although the full household tariff is now higher than the industrial rate, approximately 40% of Romania's domestic electricity consumers qualify for the 'social tariff', a lifeline rate introduced to protect vulnerable sections of the population from the worst effects of price increases. Approximately 30% of Romania's total building stock receives its heat and hot water from district heating systems, a figure that rises to 58% in urban areas. District heating accounts for about 60% of the country's total heat and hot water demand. A total of 68 towns and cities have district heating networks, 40 of which receive heat from CONEL-owned power plant. The performance of the district heating systems tends to be poor, partly because of insufficient insulation of pipes, fuel shortages and excessive corrosion leading to hot water loss. But perhaps the most important factor leading to poor performance is the uncontrolled expansion of networks in the past, with the result that certain systems can only meet about 60% of peak heat demand. Requirements are usually met by supplementing district heat with coal or wood burnt in open hearths. (Country Profile, Romania)

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<sup>12</sup> World Bank Project - Social Sector Adjustment Credit in Macedonia.

**Croatia:** Tariffs are twice as high as in other comparable economies. Households are forced to pay the inefficiencies in the system (cost of inefficiencies are being passed on to costumers). As much as 25 % of electricity consumed is not paid or paid with considerable delay. (Madzerevich and Sujster, 2000)

54. Standards of construction were poor and, in the long run, may mean that privatisation has saddled the occupiers with liabilities in the form of maintenance obligations. Without adequate maintenance, which may be unaffordable for many of the occupiers, apartment blocks are likely to deteriorate rapidly.

55. The proportion and number of households with substantial arrears (rent, utilities, common fees) has increased being threatened either by foreclosure or cut off the relevant service. No reliable statistical data is available. The problem of common fees is a matter of condominium governing bodies (the common assembly of owners and the managing board/manager – not a legal entity);

In **Bulgaria**, utility tariff is widespread problem. In the case of heating, the group of threatened households is that of occupying dwellings with central heating 589,000; the first self-defending step at insolvency has been voluntary giving up of central heating; estimates based on heating companies' reports show that the radiators of 50% of those with central heating are cold (about 300,000 households – 10% of all); only in Sofia 207,000 households have given up central heating (entirely or partially) – this makes 58% of all dwellings with central heating and 44% of all households; further, the central-heating systems were abandoned in several medium-sized towns and in another 3 they are facing collapse (again due to mass voluntary refusal of this service); the seriousness of this issue is supported by the intention to introduce a legislative reform, aimed at transforming the debt to heating companies into a loan – then the dwelling becomes a collateral and is a subject of foreclosure. In **electricity** exact arrears rates are not available; estimates suggest 5% of all households; by rule, Gypsy minorities create the most serious problems – whole quarters have suffered temporary cuts of electricity, but were later switched on again to ease the resulting social tensions; a legal reform envisages a mechanism for paying electricity subsidies directly to the supplying companies (because now these subsidies are misused for food); (Network report, Bulgaria, 2000)

56. Since the price of their home was relatively low for former tenants, household income could be spent on other essential or non-essential commodities. It is widely reported that this 'housing policy' together with the strong family ties which fostered the transfer and exchange of food and other consumables from the rural to the urban population actually enabled many Romanians to survive the hardship of the past decade. (UN, 2001) This is one fact, which supports housing as a shock absorber thesis (Buckley-Gurenco, 199X).

## 2. Access to the market: different segments and different income groups

57. The housing prices are an indicator of the macroeconomic changes and the strategy of the household sector towards housing. The new phenomenon in the housing sector is the fluctuation in house prices. The transitional recession, which is accompanied by the macroeconomic restriction has led to a **general housing price decrease** in the secondary market.<sup>13</sup> There is no reliable data to support this conclusion, but the experts of the Housing Network provided data on the price of different types of housing<sup>14</sup>.

We defined 5 types of houses, and the country experts estimated the price of the units:

Type 1: Capital city, 30-45 minutes traveling distance from the center, housing estates built in 70s and 80s, average condition, 2-room apartment

Type 2: Capital city good location, suburban type of housing, built in the 90s, 100-120 m<sup>2</sup>

Type 3: Capital city, traditional suburban/village environment, not high prestige, family house built before 1990, 100-120 m<sup>2</sup>

Type 4: Small city with inhabitants of 30-50 thousand, housing estates built in 70s and 80s, average condition, 2-rooms apartment,

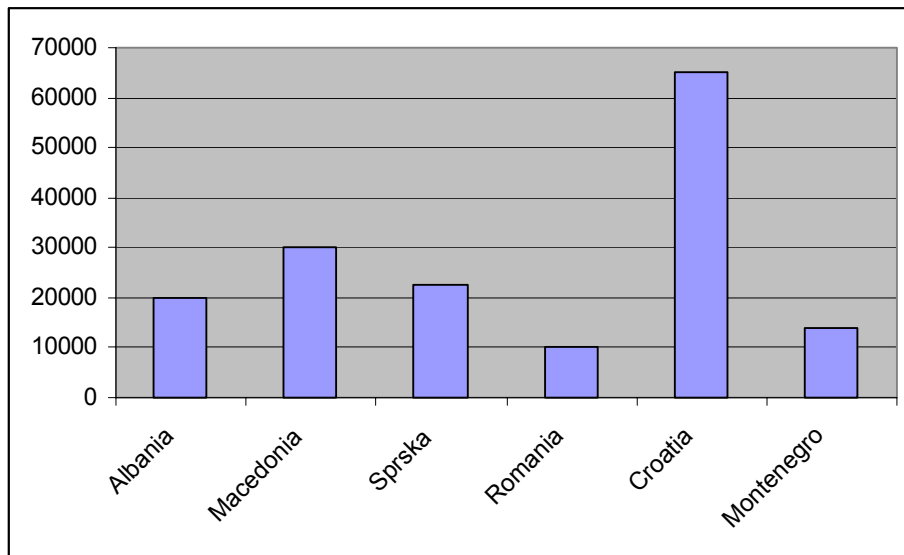
Type 5: Town/Village (less than 30 thousand inhabitants), family house built before 1990, 100-120 m<sup>2</sup>

**Table 8 The prices of the different types of housing units, in USD**

	Albania	Macedonia	Sprska	Romania	Croatia	Montenegro
type 1	20000	30000	23000	10000	65000	14000
type 2	200000	77500	91000	125000	170000	78000
type 3	17500	50000	54000	20000	110000	n.a
type 4	14000	19000	45000	3500	30000	3500
type 5	6250	35000	32000	11000	50000	n.a

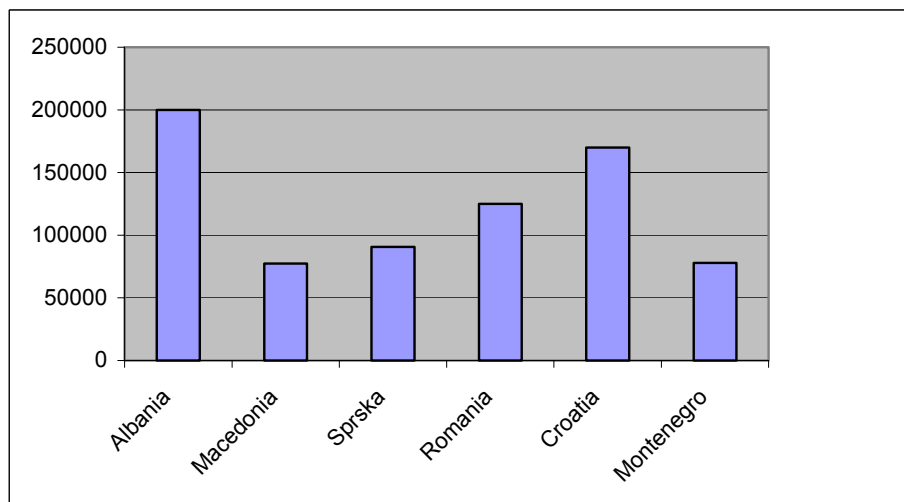
<sup>13</sup> In Bulgaria for example between 1990 and 1994 house prices increased by 2,7, general prices by 37, and income by 12. As a result of these changes the House price/income ration decreased to 5,8 (UN, 1996).

<sup>14</sup> This is not a statistical survey but give a good insight into the nature of the problem, and demonstrate the importance of the housing indicators developing housing policy.



**Figure 4 The average price of Type 1 in USD**

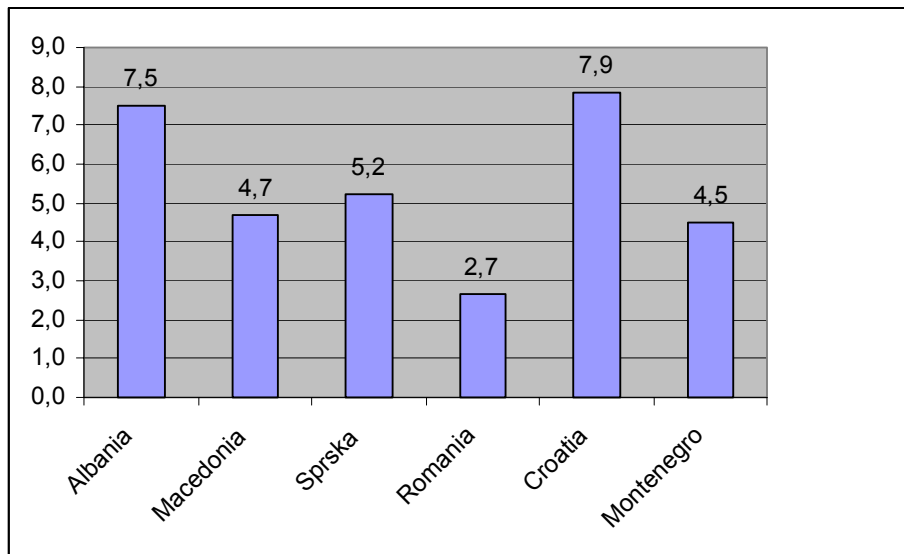
58. Looking at the price of typical new housing estate apartment, it is two times higher in Croatia (with the highest GDP) than in countries at the middle range, and 6 times higher than in Romania. The polarisation of the housing prices has been a new element in these housing systems. Among the five types of housing units the differences are huge, first of all because of “Type 2”, which represents the “elite” housing unit. The price differences are more than 10 times, which indicates the sub-market for the high-income groups (foreigners, etc.).



**Figure 5 The average price of Type 2 in USD**

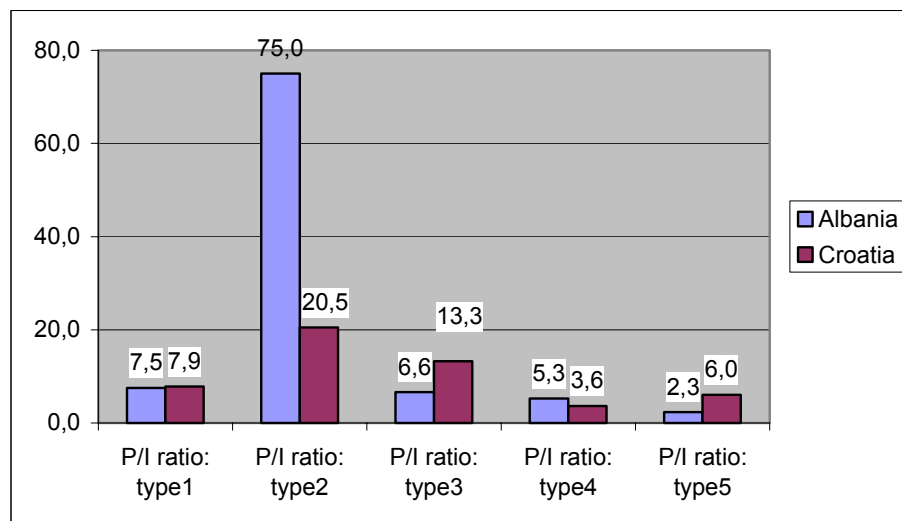
59. To study the affordability problem, we should find the medium price housing, and compare this to the medium household income.

In our estimates we took the salary of a typical public servant (teacher with 5 years experience) and the salary of a typical worker in the informal market (cleaning woman and a handyman). We defined the median household salary between the informal market wage and public sector, and estimated the average size of the earners per household at 1.7. It is important to emphasize that this procedure is just to help to reach some reasonable estimates for the household income.



**Figure 6 Estimated house price/Income ratio (Type 1)**

Croatia and Albania have a P/I ratio higher than the “acceptable” figure. In both cases the high demand for the housing in the capital city gives an explanation. The P/I ratio in cities outside the capital seems to be much lower.



**Figure 7 P/I ratios in Albania and Croatia**

60. The typical loan to value ratio (LTV) is very low because of the low incomes. So the down payment reaches 75 % of value of the houses or more.

“According to some analyses, the affordable apartment price should not be higher than four annual household incomes, with loan repayment periods and interest rates that would burden the average monthly household income within the limits from 20 to 30%. At present, the apartment price per square meter in the Republic of Croatia ranges between 2 and 3 average monthly wages, or the price of an average apartment of 50 sq.m. amounts to 10 to 15 average annual incomes of the employee which, along with bank loans approved for the period of up to 15 years, interest rates, depending on the repayment period, from 8 to 10%, and deposit from 10 to 20%, makes the apartment unaffordable for all the persons with medium or low incomes.” (Country report, Croatia)

61. The decisive factor on the demand side is the affordability issue. The majority of the households cannot afford a mortgage on market terms. The house price/income ratio is so high that from nominal and official incomes an ordinary household cannot afford a normal size loan. The role of the hidden economy is crucial in these countries.

In 1998 an average-income household had to spend half of its income on rent and needed 9 yearly incomes to buy a 75 sq dwelling. (Habitat, **Bulgaria**, 2000)

In **Romania** the prices of existing dwellings cater for a wide range of household budgets. Rough estimates of the price-to-income ratio for existing housing appear to fall within the same range as in a number of other industrialized countries (2.4 to 6.6). For example, a household can purchase an existing two-room flat in Bucharest for as little as \$7,000, or as much as \$60,000. There is no general rule for the price of a single-family home (known locally as a villa). In urban areas, a relatively small number of villas have been built recently, many by high-income households. While prices for luxury units can exceed \$100,000, it is possible to buy a modest villa with services on the outskirts of Bucharest for around \$25,000 to \$30,000. (UN, 2001)

In Bulgaria, currently there are only two sources for housing financing available: own savings (cash payment) and housing mortgages. The housing investments structure can be characterized by just one indicator – credit-to-value ratio. In 1997 it was just 0.06, i.e. the share of credit was only 6% of new housing investments.

The relation of a **new housing** total price (including land) to the net household income is **10.1** (as of December 2000, expert estimate, based on statistical average household income and market newspaper data for the 28 largest local housing markets) Network, 2000

## **E. Housing finance**

62. There are different types of housing finance system which successfully integrated housing finance into the economy. Countries developed a certain combination of the basic models, which are the contractual system, commercial bank model, mortgage bank model, and the secondary mortgage bank model. In the international experience there are huge differences explained by the individual historical development and tradition. Beyond the historical factors the explanation for different institutional settings in the developing countries lies, to a great extent, in the government regulations, such as weighting rules in the capital requirements, lack of the standardization of the loans, existence of the competitive on-balance sheet funding instruments.

63. One of the key questions is in which direction housing finance will go in the countries of South-East Europe. The general tendency in the transition countries seems to be a move towards an institutional structure for providing private housing finance, which includes three basic elements: universal banking sector, some version of mortgage banking as a potential mode of accessing housing funds from the capital markets, and the subsidized *bausparkasse* (contract saving model) model.

64. A housing finance system has just started to develop in the region, and it is in an early stage. Commercial banks are the typical financial institutions, which have mortgage products, which, in the beginning, are not really mortgage but more loan types tied to housing. Loans are generally short-term, the equity requirement is high and interest rates are variable. In many cases, houses are financed on installment contracts with the developers. In fact, people may prefer this method, since they may not want to obligate themselves to a long-term mortgage when their economic future is uncertain. The combination of low wages and high costs of financing (down payment and interest) make it very difficult for most citizens to afford a home. Whatever the explanation is, the market for mortgage loan has not developed, and there are explanations for it on both the demand and the supply side.

65. Governments identify the lack of housing finance as a main constraint for the developing real estate market. There are two approaches to the problem: developing financial institutions with potential role on the mortgage market, or setting up state institutions who will be active in the housing market as a type of quasi private institution.

The example for the successful “public-private” institution is the case of the Fannie Mae and Freddie Mac in the U.S. These were founded as public institutions to provide a way for mortgages to be shifted from the small banks and thrifts that issued them to the capital markets, thus reducing the risks borne by lenders and giving them the liquidity to lend again. These institutions enjoy an implicit guarantee, because the financial market believes that if things go wrong, the government will come to their rescue. They retain powerful legacy rights, such as an exemption from state and local taxes, and from oversight by the Securities and Exchange Commission, America’s main market regulator. Their debt can be used as collateral by banks for tax deposits.

And, unlike other corporate loans or bonds, banks can hold as much of it as they like without making warning lights flash on their, or the regulators', risk management systems. Five members of each company's board are appointed by the president of the United States. This can be considered as a hidden subsidy dedicated to these institutions, which are ultimately financed by householders, either through taxes or through the reduced accumulation of wealth.

## **1. Types of housing finance institutions**

### **1.1. National Housing Agencies: financial institute?**

66. The typical solution was the creation of the National Housing Agency, which was organized as a budgetary institution part of the government (like a department of the ministry) or an off-budget institution. The general feature of this model is the dependency on the state budget, or on the revenue defined by the government. For example, the privatization revenue, if there was any, could be assigned to the NHA. One of the NHA's roles is to manage subsidy programs, some of them with a credit element. There are lots of doubts about the success of this model. We do not have enough empirical evidence to judge, but in principle one option would be that NHA becomes just a "de-concentrated" unit of the government depending entirely on the yearly budget allocation. The other option is that it becomes a semi-private institute competing or cooperating with the private sector (and crowd it out), issuing and/or guaranteeing mortgage bonds as primary source of funding and lending it to the costumers backed by the collateral. Typically, the bond issue, as well the loan conditions are favorably supported by direct or indirect subsidies. NHA institutions could play the role of the developer as well, competing or cooperating with the private sector. (Serbian Agency for Housing Construction).

As an example in **Romania**, the government has drafted and passed two laws of major impact in the field of housing. The first one is the law creating the new National Housing Agency. This law was promulgated on July 13, 1998, and authorized the National Housing Agency to make mortgage loans through banking institutions to Romanians with special loan facilities. Initially, housing funding is made available by the government. It also creates for the Agency the possibilities to issue mortgage obligations and to institute a mortgage obligation guarantee fund. The second law, promulgated in June 1999, formalizes the mortgage credit system including the issuance of mortgage bonds and of mortgage backed securities. The National Housing Agency is a public interest institution, for the coordination of financial resources in housing construction. "The aim of the National Housing Agency is to create financial packages and attract management resources for the construction, purchase, rehabilitation, consolidation and extension of dwellings, including for rent". The Agency is not a financial institution: it is a 'manager-mediator' between banks, developers and individuals. (UN, 2001)

## 1.2. Commercial banks

67. **Commercial banks** use deposit for their lending. They are usually the major financial institutions in the housing sector. (In EU the deposit taking system accounts for 62% of funding mortgage loans.) This institution has to deal with the maturity match issue, which gives a higher liquidity risk to this instrument. The relatively cheap cost of this resource could compensate for the risk. The banking law applies in cases of foreclosure, which means in practice that the lender would have to go to court to foreclose, and, if the court decision is favourable, supply the evicted borrower with alternative housing. Although this is a socially supportive measure, it is proving to be an impediment to institutions, which might otherwise be willing to lend money for housing. However, it is a good argument for more social housing to be built for those evicted. The national saving banks were in monopoly situation in the housing loan market, as traditionally one bank was authorized to provide loans for households.

68. Appropriate funding for long-term credit is also an important prerequisite for housing finance. Retail deposits are still the primary financial resources for housing loans even in advanced markets countries. The relative importance of the deposit finance will be very high, and probably the alternative funding method will gain ground only gradually. Probably there is no single successful funding system.

In **Bulgaria**, the recently established Bank SSB (that replaced the ex-State Savings Bank in 1999) inherited the monopoly in the sphere of housing finance. Refinancing of long-term credits (housing mortgages) relies on the population's deposits. The rest of full-licensed Bulgarian banks, including private ones, are eligible to issue housing loans as well, but they do not demonstrate interest in this business yet. Thus they do not compete with the Bank SSB. Housing markets and housing crediting develop without correlation, because the credit-to-value ratio is very low. On the one hand, this is an evidence for high equity, and, on the other, for credit insolvency of potential borrowers. The number of new housing credits has fallen from 40,180 in 1991 down to 1,244 in 1996 and their average size has increased respectively from \$512 to \$809. Such amounts have been enough to cover respectively the construction cost of 3.4 sq.m. and 4.3 sq.m. housing floor space. Current low-income levels lead to distortions in household budgets. The ongoing increase of housing utility and service prices to cost-covering levels shrinks saving capabilities even of above-medium income groups. Therefore, the strong equity position of most homeowners cannot be expressed in a demand for new credits - neither for better housing, nor even for renewal of currently occupied one. The only mortgage instrument in the sphere of housing is the annuity credit (a loan with a fixed interest rate, fixed period of payment and equal installments). In fact, "fixed" is only a label, as the interest rate is periodically adjusted to the basic market interest rate and the debtors are free to prepay the mortgage. Thus it can be qualified as a type of adjustable rate mortgage (ARM). All recent attempts to introduce more flexible mortgage instruments (price-level adjustable mortgage - PLAM and dual-indexed mortgage - DIM) have failed due to continuous and unpredictable unfavorable macroeconomic conditions. Since 1999, the housing loans offered have been adequate to market prices, but far from solvency.

The conditions to get a loan by the end of 1999 were as follows: (1) a credit amounting to 70 % of investment/market value of the collateral; (2) a rate of interest - 15.5% when the applicant has a housing deposit (10.8%); (3) above the basic interest rate); (4) a rate of interest – 16.6 % when borrowers have no housing deposit (11.8% above the basic interest rate); maximum period for paying off (maturity) - 9 years. Besides that, the monthly income per capita, remaining after deducting of the installments, should be not less than the current minimum salary (determined periodically by the Council of Ministers). During 1997, only 2,876 housing loans were granted, amounting to 8.7 million USD, compared to 40,180 loans and an amount of 20.6 million USD for 1991. Thus in practice, since 1992, housing crediting has been effectively blocked not due to insufficient loanable funds, but due to insolvency. Demand is very low not only for long-term mortgages, but for construction loans, too. In view of the small and still diminishing solvency demand for long-term housing credits and the availability of huge amount of savings in the SSB (4.4 bil.lv. at the end of 1997), sufficiency of loanable funds is not a problem now. The SSB still attracts about 70% of the population's savings. This defines the population as a net creditor of the whole economy by way of active participation of SSB on the Interbank Money Market and the Government Securities Market. The future encouragement of savings is a necessity of the financial system. The inherited system of housing savings in the SSB is still unchanged. The new economic conditions made saving for housing unattractive, as the interest difference between fixed-term saving deposits and housing deposits has been positive. Thus the relative share of housing deposits in 1997 has fallen down to 1.6% from the total savings in the SSB, their average size being 16,800 lv (5% of the construction cost of 1 sq.m. housing surface area). Evidently the role of housing saving has become a formal one. The only incentive to maintain a housing deposit is the lower interest of loans (1%). (National Response on Housing Finance Workshop, 2000 January) In Bulgaria, currently all housing credits are mortgage credits and no other form of housing financing is being used. DSK Bank enjoys a quasi monopoly situation; they issue 90 % of the housing loans. The share of the outstanding mortgage loan in GDP is 0.7 %, which shows the crisis of the housing finance sector. (Tzveta, et all, 2000)

**Table 9 Housing loans for a typical market client in Croatia**

<b>Purpose:</b>	<b>Housing</b>
Loan amount:	10,000 EUR – 100,000 EUR
Term:	up to 15 years
Interest rate:	9.00%, p.a. floating – without deposit 10.00%, p.a. floating – with 20% deposit
Fee:	up to 25,000 EUR – 3% 25,000 – 50,000 EUR – 2% 50,000 EUR and above – 1%
Preconditions:	- debtor's monthly income should be 3x higher than loan annuity or sum of the debtor's and co-debtor's monthly incomes should be 3x higher than loan annuity debtor's spouse is an obligatory co-debtor min. monthly salary of debtor amounts to 2,500 HRK co-debtors and guarantors should have min. monthly income in amount to 2,000 HRK, each
Security:	2-3 guarantors (sum of their monthly incomes must be 3x higher than loan annuity) bills of exchange 2 bills of exchange of a private company if debtor owns such company debenture bond if the loan participant is owner of private company fiduciary transfer of ownership at the real estate (estimated value of the real estate should be in amount of 130% to requested loan)

In Albania during 1994-1996, **Saving Bank** was performing with success in the housing sector and was the main bank issuing a loan with "good" terms from the borrower's point of view. In 1996, according to the act "On the state contribution for the homeless families", the SB was one of the mechanisms of the implementation of this law. After the fall of the pyramid schemes, the SB was no more allowed by the government and IMF to extend its activities and thus even to give loans for housing.

**Table 10 Terms of the loan in three main commercial banks in Albania**

<b>Banks/ Terms of the loan</b>	<b>American Bank</b>	<b>Malaysian bank</b>	<b>Italo-Albanese Bank</b>
<b>Collateral</b>	Guaranteeing the loan through a mortgage preferably the object for which the loan is being taken	As guaranty is registered the apartment has to be insured towards earthquakes and fire	As guaranty is registered the apartment, or the apartment of the parents
<b>Interest rate</b>	Fixed and between 10-13% per annum	Monthly fixed interest of 10% on dollar bases	Depends on the market; in 1996 it was 7% now it is 11% in USD
<b>Maturity</b>	10 years without grace period	10 years without grace period	5-7 years
<b>Loan-to-value ratio</b>	60% of the business plan of the client	50% of the total investment of the client	50% of the total investment of the client
<b>Monthly charges</b>	Not more than 50% of family monthly income	Not more than 50% of family monthly income	
<b>Maximum amount of loan</b>	\$60,000 USD	\$30,000 USD	
<b>Profile of the client</b>	Businessmen, or small private activities combined with regular salaries, or those that are employed by the foreign agencies	Businessmen, or small private activities combined with regular salaries, or those that are employed by the foreign agencies	
<b>Risks considered</b>	Registration of the mortgage in the hypothec, the regularity of income, the regularity of its business, or the time and efforts of the bank to realise this credit	Insecurity in executing the law and regulations on lien	Repayment insecurity, insecurity in executing the law and regulations on lien, mortgage law not well developed, Albania as a high risk country
<b>Monthly installments</b>		245 USD/month for a loan of 10,000USD and a payback period of 5 years, and 675 USD for a loan of 30,000 with the same conditions	
<b>No. Clients</b>		138	
<b>Loan amount</b>		2 436 900, 86 USD	

Source: Doris Andoni, 2000, National Housing Policy and its impact on the poor in Albania

69. Slowly some competition has developed in the housing market in the region. But it seems very much the beginning, as the banks are not forced by the market to issue mortgage loans. They give loan to the best creditworthy clients, but are not open to a wider circle of the customers.

ALPHA BANK ROMANIA has put on the market Alpha 810 Housing dwellings loan, starting September 2001, allowing clients to borrow up to US\$50,000 for a period of 10 years. The product is conceived so that a wide range of people could build, buy or refurbish the house of their dreams. People who want to build or buy a house need no additional guarantees but the mortgage on the house itself. The loan enables clients to build, buy or refurbish a house and pay later in equal monthly installments, long-term loans - up to 10 years, has a very high threshold for lending - US\$50,000, has a competitive 12.5% interest rate and it provides for fixed installments every month. The bank covers 70% of the cost of a house, so the client needs to bring only 30% as advance payment. There are multiple advantages that come with Alpha 810 Housing: the product is innovative, because it answers clients' needs in a modern way, tailored to their income streams; it is affordable, as clients with net monthly incomes of even US\$250 may be eligible for this loan; it is rewarding, because it gives the best value for people's money; it is time saving, as clients needn't queue up at the bank's counters to pay the installments for this is done automatically from their account. The nine branches of Alpha Bank Romania in Arad, Baia Mare, Bucharest, Cluj Napoca, Constanta, Iasi, Sibiu and Timisoara are ready to serve clients.

In FY 2000, the Bulgarian American Enterprise Fund began a residential mortgage lending program; entered into a joint venture with a local pension company; and continued to play an important financing role within sectors not served by commercial banks. In 1999, the Bulgaria Fund turned profitable, earning about \$181,000 in that year and about \$365,000 in FY 2000.

### **1.3. Contract savings: savings bank**

70. Bausparkassens are specialized financial institutions designed to collect savings deposits on a regular basis at a low, below-market rate and recycle the low rate on their funding into low rates on loans for "housing purposes". The savers enjoy a premium after savings. In many Central and East European economies subsidized savings schemes of the German type have been exported to encourage saving for housing.<sup>15</sup>

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<sup>15</sup> As concluded by Lea and Renaud (1994), such systems are inappropriate for high-inflation countries, where the bulk of the subsidy is going towards offsetting inflation, and the net rewards for saving in the system relative to in a bank are very dependent on the course of inflation during the contract period. Moreover, the fears that these systems could be very expensive, and that the budget burden would be politically difficult to manage, have been confirmed. The situation in the Czech Republic, where the annual bonus has been untouchable while market interest rates have plummeted, points up the extreme impacts that are possible. Reports from Hungary and Slovakia indicate that any decline in new contracts prompts immediate pressure to boost subsidies further, confirming the expectation that the inherently unstable structure of the systems distorts political decisions about what form housing subsidies should take.

**Croatia.** The Law on Housing Savings and Government Stimulation of Housing Savings (entered to in to force January 1,1998.) provides the legal framework for establishing housing savings banks, which collect the funds on the basis of so- called solidarity savings, where the deposit is increased by the annual savings deposit - maximum HRK 1,250 (150 USD) per person per year. Also, family savings are possible which multiply the government stimulation depending on the number of persons involved. The interest rate is fixed, 6% on the loan, and 3% on the savings. Total number of saving contracts up to now: 37,521, contractual amount is 257 million EUR.

**Table 11 Housing loans at Building Society Wüstenrot (loans based on housing savings)**

<b>Purpose:</b>	<b>Housing</b>
Loan amount:	750 EUR – 100.000 EUR
Term:	up to 11% years
Interest rate:	5,00%, p.a. floating
Fee:	1,0%
Min. savings period:	2 years
Preconditions:	- debtor´s monthly income must be 3x higher than loan annuity or sum of the debtor´s and co-debtors (1or 2 co-debtors possible) monthly incomes should be 3x higher than loan annuity
Security:	- 2 guarantors (sum of their monthly incomes must be 3x higher than loan annuity - if debtor and co-debtor (each of them) have monthly incomes min. 3x higher than loan annuity, one guarantor is enough - bills of exchange - debenture bond - if the loan amount exceeds 5,000 EUR: mortgage on the real estate (estimated value of the real estate should be in amount of 100% to contractual amount)

Bulgarian Habitat Report expressed the need for the contractual saving banks. Over this year in particular, a study has begun that investigates the opportunities for the introduction in Bulgaria of the system for saving and credit giving that takes account of the experience of the German housing credit institutions. We hope that this system will be gladly accepted; moreover a system comparable to that one was in use in Bulgaria from 1935 to 1945.

#### 1.4. Mortgage banks

71. The **mortgage banks** are the most common types of housing finance institutions in Europe (Germany, Sweden, etc.) Though they traditionally financed their loans through retail deposits, nowadays they are closely linked with mortgage bond financing. Mortgage bonds are essentially debt securities issued by the mortgage bank and backed by mortgage loans that remain on the balance sheet of the mortgage issuer.<sup>16</sup>

In early October 2000, Bulgarian parliament passed the Mortgage Bond Law. The key peculiarity of the Bulgarian approach is that the primary mortgage market has been left on its own natural development trends, avoiding government guarantee schemes and creation of specialized institutions, e.g. mortgage bank. Another peculiarity is the exclusion of the land market from the mortgage bond framework. The purpose of the law on mortgage bonds is to establish the legal framework for issuing of this instrument on the Bulgarian financial market. The law on mortgage bonds gives every bank licensed by the Bulgarian National Bank the right to issue securities ("mortgage bonds") backed by its portfolio of credits secured by one or more first-ranking mortgages over real property (Tsveta at all, 2000). Today at the Bulgarian Stock Exchange the first deal with mortgage bonds was concluded. 50 mortgage bonds of the first emission of the BACB were sold at prices higher than the nominal prices at the free bond market. Securities are traded at EUR 1,018, which is over the nominal value of EUR 1,000. According to the development manager of BACB Ivailo Botev, that is an indication of the good evaluation of investors for the bank and for the expectations of its development. If that trend proceeds the BACB mortgage bonds owners can rely not only on high profits and low risk, but also to good liquidity of their investment. BACB is the first bank, which issues mortgage bonds in Bulgaria. At the end of July the bank issued bonds for EUR 3.212 M for a three-year period and annual interest of 7.75 per cent, while the received orders exceeded the planned emission volume. Pension Funds purchased most of the bonds. It is expected that they will hold the bonds for the whole period. Probably today's deal is concluded by some of the other investors, who purchased bonds of the bank. /News provided by BEF News Desk/

Several government resolutions from 1990, 1991 and 1992 provided the mechanism for housing loans. The traditional source for a construction loan is the Savings and Deposits Bank. The Romanian Government channeled resources through this Bank specifically to facilitate housing construction or purchase.

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<sup>16</sup> Through a special instrument (mortgage back securities) the mortgage bank can sell the loans to investors. In this case the banks will have revenues from the loan, but do not keep them in their books. The risks are passed to the investor as well. This scheme is too premature in the region. The Agency for Housing Mortgage Lending was set up (given the licence by the Central Bank of Russia) in 1999. It is an independent joint stock company, 51 % of its shares are owned by the Government of Russia. The GR will fully guarantee the debt issued by the Agency, but the debt is not accorded any tax advantages. The Agency buys the qualifying loans, that is, buys the right of claims. (Struyk and Kosareva, 1999)

Now, some of these resolutions have been rescinded. The Law 190/1999 on Mortgage Credit for Investment in Property enabled the introduction of a conventional mortgage loan. According to this Law, the credit banks, the National Housing Agency, the Savings and Deposits Bank, and other financial institutions (including any special mortgage funds) are authorized to grant mortgage credits. Romania has no special law on mortgages, but some valid provisions can be found in the Civil Code, and these, following traditional mortgage practice, are reflected in the present Law. \*UN, 2001)

72. Capital markets are an alternative source of funds for housing loans that have recently increased in importance in many advanced countries. There are generally two ways to raise funds from capital markets for mortgage loans: mortgage bonds and mortgage-back securities. Mortgage bond legislation has been introduced in some of the transitional countries (Hungary, Poland, Czech Republic, Bulgaria, Russia, Latvia, Estonia). But the development of the mortgage bond market is tied to the development of the pension fund and life insurance, which are the most important investors.

Other FDI alternatives are in the area of pensions, healthcare insurance, mortgages and life insurance. In the first two, the government is still a dominant player. On the aftermath of the attacks on WTC, global insurance leaders would think twice whether to bid for upcoming privatization of DZI, Bulgaria's State Insurance Institute. Although mortgages reemerged after 1998 and there are already issues of mortgage bonds (well received by investors), a provisional longer-term prospect of foreign investment is hampered by institutional underdevelopment and relative closeness of the domestic mortgage market.

## **2. Housing finance issues**

### **2.1. Mortgage insurance**

A strategic implementation of a mortgage loan guarantee program would provide access to mortgage financing for greater opportunities to housing loan and would greatly assist in developing a mortgage market in countries in transition. Planning and implementing such a national mortgage loan guarantee program would greatly assist the local lending institutions to move quickly into residential lending operations to facilitate accessibility to home ownership. Government support has been key to improved housing conditions of developed countries, and it is also true for developing markets. Initially a **government-sponsored agency** is needed and must be mandated by the government to take the lead role in all aspects related to the housing industry, in particular housing finance. Appropriate processes and procedures must be developed to deliver the housing program in participation with interested organizations. A liquid and solvable mortgage loan guarantee fund must be instituted.

A national mortgage loan guarantee program would contribute to the development of the market driven economy by: a) assisting lending institutions in making viable mortgage credit loans to citizens and stimulating the housing construction industry; b) helping promoters and housing construction builders in obtaining construction financing for residential housing units from approved lending institutions; c) bringing standardization to the local mortgage loan industry where all participants would understand the mortgage products available for their citizens and its financial and risk implications; d) giving the required transparency presently lacking in those countries in transition, e) increasing volumes of profitable mortgage lending and opportunities to retain and offer other services to their clients for financial institutions; f) promoting standardization required for securitization purposes by assisting potential local and foreign investors in assessing the risk associated with mortgage loans; g) contributing to increased access and democratization of housing ownership. (Gilles E. Girard, consultant).

## **2.2. Risk management**

73. One advantage of the privatization is that the majority of the households already have some equity in their homes, and these are debt-free. Those wanting to move to a better home do not, therefore, need to borrow the full price. That cuts the risk. The credit risk is not high in terms of the actual LTV ratio. The borrower in arrears – in most of the cases – sells their property and moves to another lower value property. But in several cases there is no secondary market that enables defaulting mortgagors to sell their property prior to a sale-in-execution. Moreover, from the financial institution's point of view, the lack of the proper secondary market could lead to a huge loss, even at low LTV ratio. In small villages, for example, there could be a strong pressure against people who are willing to buy the defaulted properties. (Even worse when a criminal group "organizes" the buying.) The other obstacle for the market development could be different expectations of the lender. For example, in the case of repossession the lender is expected to provide a rented flat for a year in Russia. And even after a recent revision to encourage mortgages, Russian law—still untested at the highest level—may forbid the eviction of families with children. (Economist, 2000)

74. There are different types of risks related to housing finance. The role of managing risks related to the macroeconomic situation is in the hand of the central government, such as the inflation risk, price decline in property market, etc. However there are risks, which should be controlled by the financial institutions, e.g. operational risk or the credit risk. An efficient housing finance system requires other supplementary schemes to enhance lending, such as title insurance, mortgage insurance and deposit insurance, public access to the credit history of the potential borrower, or sharing information to decrease the "transaction cost" of the housing market, like price information or clear comparative mortgage cost, etc. Standardisation could be part of these schemes.

### **2.3. Mortgage products, competition and real interest rate**

75. The financial institutions develop mortgage products which fit into the macroeconomic environment (inflation, etc.) and the arrangement of sharing risks among the actors. The key issue is the competition among the financial institutions, which could lead to a reasonable level of the real interest rate. The question is whether the banks are forced to make loans or whether they can survive with a more profitable and less risky investment, like government bonds? The typical bank in the region has plenty of deposits, but finding somewhere useful to lend the money is difficult.

In Bulgaria, loans to buy housing or for new housing construction works are allocated in almost all cases by one bank—The State Savings Bank. The debt instrument offered by the Bank is annuity credit. That type of loan has a fixed interest rate /16-17%/, fixed term of repayment /10 years/ and even repayment schedules-installments. The maximum amount for the loan size is up to 70% of the investment volume. The lender reserves its right to alter the “fixed” interest rate in accordance with changes in the basis rate; the borrower has the right to repay the loan in shorter than the agreed time frames.

76. We can **conclude** that housing loans play very limited role in housing finance in the transitional economies. This is true for the most developed countries in Central Europe. There are several possible factors, which could explain this fact (Hegedüs-Várhegyi, 2000, Dough, 1999). It is important to evaluate these factors with respect to South-Eastern Europe as well. One explanation is the importance of the inheritance and parents attitude providing accommodation to their children as a social expectation rooted in culture and tradition. Second explanation is related to the “cash economy “ feature of the countries in the region. (High owner occupation supports this argument.) Third is “borrower reluctance” generally against loans and reluctance to pay the effective cost of housing. (Dough, 1999) Other studies (Hegedüs-Várhegyi, 2000) argue that in the period of house price decrease it is rational on the side of the households not to invest and not to take loans

## F. Housing subsidies

77. The housing subsidies are the centre of the housing policy discussion in the transitional countries. After the transition the budget-subsidies were cut because of the fiscal pressure, but housing has remained subsidised through indirect subsidies. There was another important channel for subsidising housing: the housing investment of the state owned or public companies. The privatisation and the financial pressure forced these companies to stop subsidising housing. The most important effect of the subsidy decrease was the decline of housing investment (new construction). Cutting the subsidies for the sector led to a deficit in the sector, which has not been bridged by the household sector and private sector. Thus the housing sector had been contracted in the first ten years.

78. There are several arguments which favor the reduction of the subsidies in the housing system and replace the subsidy with an efficient housing finance system. The international trend in the subsidy program shows a clear tendency toward decreasing the subsidies and targeting to needy people, or to the household with a special housing problem (E.g. reconstruction of the war damages, or low cost housing program for roma population, or tax incentives aimed at stopping the decline of inner-cities).

79. **Housing allowances** are the most powerful subsidy to provide a safety net for the households whose income could not keep up with the price increase (unemployed, pensioners, one-headed families). The experience of the countries in transition was that the housing allowances could give only a limited help to these households forcing them to radically decrease their consumption (including housing) or to become a household with arrears with the constant threat to be evicted or lose the property right.

In **Bulgaria**, payment of running costs of existing housing units – cash and in-kind heating subsidies, targeted to low-income households; for the heating season 1999/2000, 12 million DM have been allocated to 575,000 poor households (less than 21 DM per household on average); another 55 million DM have been targeted to vulnerable people (handicapped, elderly, orphans) – for social support and additional “energy consumption support”; the subsidies above are under the social safety net, administered by the Ministry of Labor and Social Policy and not by the Ministry of Regional Development and Public Works (the last being responsible for the housing policy). (Network, 2000)

80. To develop a new housing finance system the housing policy is going to use subsidies. The other recent examples in the region is that after the stabilization of the economy the politics again turn to subsidies as an instrument influencing housing and politics. There are different types of subsidies related to housing finance. The aim of the **interest rate subsidy** is to increase the affordability of the mortgage loans. Different types of the subsidy scheme are known. One solution is when the government assumes the financial burden of interest rate risk providing the difference between the market rate and the fixed rate to the financial institution. The other solution is when the government just pays a certain percentage for the cost of the loan. The different type of **guarantee programs** can help the development of the housing finance system. The government can guarantee the bonds issues by the mortgage banks, or can guarantee housing loans up to certain percentage of the equity. The government can run a special guarantee

program for the low-income households to increase the affordability of the housing mortgage. There can be different designs as well. For example, the government can guarantee only a certain percentage of the losses, sharing the risk with the mortgage originator. **Down payment subsidies** for homebuyers directly increase the affordability of the households. A lump-sum subsidy for housing could be given to the households based on the number of children, or according to any other criteria. Among the criteria usually are factors like new or "old" housing, the value or standard of the house bought (excluding "luxury" units), mean testing, etc.

In Romania, the state supports housing (new construction, renovation and house purchase). Seven groups of the population are entitled to a single subsidy varying between 500,000 lei and 30 per cent of the dwelling's contract purchase price. Under the 1999 amendments the main support has to come from local budgets. Unfortunately, there are no data on the number of dwellings built under this Ordinance. (UN, 2001) The same mechanism is provided in the Housing Act. It stipulates that four population groups should benefit from State subsidies: young married couples, each aged up to 35 on the date of purchasing the dwelling; participants in the 1989 Romanian revolution and their families; persons skilled in agriculture, education, health, public administration, as well as clergymen and others supported by local councils, who settle in a rural area. The subsidy - within the limits of budgetary provisions, and depending on household income - can amount to 30 per cent of the purchase price at the time the dwelling is contracted. The remainder, after the initial minimum compulsory down payment of 10 per cent, can be paid in monthly installments over 20 years. These conditions are available to a purchaser once and only if he does not already own a dwelling. The owners of new dwellings are exempt from building tax for 10 years after the dwelling is purchased.

In Bulgaria, for those buying or building new housing units there are no targeted subsidies; pursuant to the "Old Savers' Act", beneficiaries get compensations (in cash or in the form of "compensation bonds") after buying or starting building a new dwelling; the same right refers to buying an existing unit; beneficiaries get 0.03 DM per "interest rate point" (under the old system each housing deposit gets "interest rate points" according to the amount and number of years staying open in the bank; the average number of points per deposit is 100,000, i.e. the average compensation is 3,000 DM) or "compensation bonds" having a nominal value of 0.03 DM /the bonds can be used for buying public land or existing public dwellings/; the amount for these compensations in the Budget 2001 is 15 million DM. (Bulgaria, Network, 2000)

81. The first special aspect of a tax subsidy is that it is defined relative to the standard tax treatment.<sup>17</sup> It is not easy to measure the tax expenditures, it is partly a technical, partly a substantial problem.<sup>18</sup>

In **Croatia**. The existing tax regulations do not give any particular alleviations in housing. There are no possibilities of subsidising apartment purchase through income tax alleviations. The value-added tax of 22% is charged at the first purchase of a newly built apartment, which considerably affects the price. The real estate sales tax at following sales is 5 %. The income tax on apartment rent if the lessee is a physical person, is 20 %, and if the lessee is in the VAT system, the tax is 22%, which is destimulating and is the main reason for unknown extent of illegal housing.

In Romania, a separate Government Ordinance deals with a subsidy for the thermal insulation of apartment buildings and district heating systems. It offers a State support to legal entities and individuals undertaking energy-related rehabilitation and the technical upgrading of buildings and associated installations. This support will involve free information for consumers, fiscal facilities for certain categories of users, and recourse to specialist agencies. Those willing to work on their own apartment buildings will benefit from tax exemption on presentation of the energy certificate for the building issued after approved improvements in thermal insulation. (UN, 2001)

Romania does not yet have a tax code, although such a code is mentioned in the National Medium-term Development Strategy for the Romanian Economy. This stipulates *inter alia*: “to ensure the effective and efficient implementation of the tax system, a code of tax procedure and a tax code (including the integration of all the tax regulations dispersed throughout Romanian legislation) will be introduced”. There are several legislative acts at general fiscal level: Law 32/1991 V3 (revised) on salary tax; Government Ordinance 73/1999 on income tax; and Government Resolution 70/1994 on profit tax. In accordance with Resolution 70/1994, the tax on profits - including those of construction companies – was 38 per cent; but it has since been reduced to 25 per cent. It should be noted that under Law 35/1991 foreign investments in construction are exempt from profit tax for a period of five years from the starting of construction. This provision applies to legal entities entered in the Trade Register before 1 January 1995, and no longer applies to other persons since that date. Romanian businesses, which invest in the construction of official, public and emergency dwellings benefit from a 75 per cent profit tax reduction for the relevant fiscal year. Taxes on real estate and built-up land are determined by Law 27/1994 on Local Taxes and Fees and in Emergency Ordinance 15/1999. Local authorities administer these taxes, paid every year by the owners of buildings. For public housing stock, the tax is paid by those managing the buildings.

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<sup>17</sup> Tax evasion is usually not listed as a type of tax subsidy, because to do so implies that there is some choice about allowing evasion.

<sup>18</sup> (1) Tax Credit: An amount is allowed to be credited to (i.e., subtracted from) the amount of taxes due. (2) Tax Deduction: An amount of expense is allowed to be deducted from income in arriving at the tax base, i.e., the amount of income subject to tax. (3) Tax Exemption: An amount of income does not even need to be included in the tax base to begin with. (4) Tax Rate Relief: Certain income is subject to a lower tax rate. (5) Tax Evasion: An amount of income is hidden from being considered in the tax base.

The real-estate tax for buildings owned by individuals is calculated at 1 per cent of the market value per year. The tax on built-up land is recalculated each year as a rate per square meter, according to category (areas A,B,C,D). It varies currently from 2,400 lei in area A (municipalities) to 150 lei in area D (villages). The land tax is paid also by the owners, save where the land is needed for certain authorized activities. Borrowers, according to Law 152/1998 are exempt from land and real-estate taxes until the loan is repaid. Law 27/1994 also levies taxes on the issue of certificates, notifications and authorizations required in the construction process, and these taxes differ according to location and land use (e.g. housing construction enjoys a 50 per cent discount on authorizations). Value-added tax (VAT) is regulated by Law 145/1999 and Government Emergency Ordinance 17/2000. These set a zero rate on the construction, upgrading and rehabilitation of dwellings. More detailed procedure is presented in Ministry of Finance Order 1026/2000. (UN, 20001)

In **Albania**, the subsidy program is managed by the National Housing Agency. The households are eligible for subsidies that comply with the national definition of "homeless". Interest rate subsidy is financed from the state budget and covers the difference between the real interest rate and the interest established by the government for those who are considered "homeless" and that ranges from 0-3%. An implicit land subsidy is included because NHA has built in public land. NHA manages two other programs as well. (a) Grant subsidy – that is given to ex-political prisoners and war invalids for their house that is built by National Housing Agency. This is a subsidy that is transferred to NHA from the state budget, therefore, the family gets the house and does not have to pay for it. (b) Privatization grant – that is the amount of subsidy that is given to a family living in a house to be given back to the original owner. It is a grant that is calculated in the same way as privatization of public houses occurred. There is no VAT tax exemption, but the household pays property tax and fee for building permission. (4 %)

82. Subsidies for the bauparkasse model. Premium for the contract saving. Usually the premium is 10-35 % of the savings up to a ceiling set by the budget law or the specific legislation.

83. Housing issue has always had a high profile in politics even before the transition. In the first part of the 90's housing become a secondary issue, but again was in front. The typical political reaction was starting "**direct state programs**" which aim to generate overspill effects on the market. The donor agencies were very much interested to start concrete programs to renovate, build, and reconstruct etc. units for the needy population. The main problem of these programs was that its effect were localized, and even could distort the market in the sense that discourage the private investors, and expect the same size subsidy by the households. The lack of the management tradition/culture some of the programs just went wrong (like in Albania 1992-1993.)

In 1992-'93, Albania could profit from a WB loan some of 10-15 million USD. This money was target for the completion of the unfinished dwellings begun between 1989-1992. The terms of this loan were that of a soft one: interest rates equal to 0 and payback period 40 years. The loan was not used properly and as a result, it has been very difficult to obtain another loan from WB or other foreign institutions. By the end of 1997 and beginning of 1998, between the Greek Government and Albanian Government has been assigned a memorandum of understanding for a long-term credit. A part of this credit will be used for supporting the housing sector. In the middle of 1998, the Government approved an act where among other issues, the Greek credit was approved to be used for the families that lost their apartments in the pyramid schemes. In total this loan is 5 billion GDR (approx. 17 million USD), interest 5%, pay-back period 25 years and grace period 7 years.

In Macedonia allocates the 25 % of its planned annual housing construction in social ownership. In 1999 the Republic of Bulgaria donated pre-fabricated housing facilities with 169 housing units that helped in resolving some of the social cases. (Habitat Report.) The Government of RM adopted a program for construction of apartments for young married couple that are to be soled under preferential conditions – 50 % participation and 10 years of the repayment. The economic analyses show that the number of the poor is increasing in the Republic of Macedonia and the same condition goes with the ARM and MOD. In the last two months, the Ministry of Defense undertook concrete steps towards the improvement of the social status of the employees, but practice shows that it has not been enough despite the good will and the high percentage raise of the incomes of certain members of the army. However, these are our tasks and responsibilities, which shall become a priority after the dealing with the crisis. For this, the Ministry of Defense and the Ministry of Interior proposed a special law. The proposal of this law envisions material security in case of unemployment, free medical services, rented apartment or a mortgage, single financial reimbursement and facilitation in the education area for the security forces' members who have taken an organized participation in the defense of the independence, the territorial integrity and sovereignty of RM and prevention of the demolition of the democratic institutions. (Magazine "Defence", no. 64 August 2001)

In **Romania**, reform of financing arrangements was assigned to the National Housing Agency set up in 1999. In order to stimulate investment in the housing sector, Act 145/1999 introduced favourable Savings Bank housing loan terms<sup>19</sup>. The loans concerned must be for the building or purchase of a housing unit. On these conditions, the Savings Bank may grant subsidised loans with the support of central government. National Housing Agency in Romania started a rental program of 38 000 units in the years of 2001-2004. The program plans to built (!) 38000 rental apartment for young people, in a scheme where they save for later buying. The price of the average unit will be more than 7 times of the average salary of a couple.

The National Agency for Housing became also functional and has developed ample programs, unfortunately still lacking financing.

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<sup>19</sup> Council of Europe, Making South-Eastern Europe a region of social cohesion: Housing Problem in South-Eastern Europe-Croatia, SEER/Housing (2000) 4, Strasbourg.

In **Serbia** In the course of 2000, the programme of “100,000 flats in the Republic of Serbia by the year of 2010” was initiated and the construction of 8366 flats was contracted. In 2001, The Serbian Agency for Construction revised the contracts for the construction of apartment buildings at all of the locations where the completion of such projects was economically feasible. The available financial funds however did not allow completing everything that was started in the year 2001. For this reason in the course of the year 2002, it is planned to complete 4160 flats in the total area of 304,763 m<sup>2</sup> in 60 towns of Serbia.

**In Bulgaria**, for instance, a housing reconstruction fund was set up to finance building and renovation programmes for publicly owned rented housing. The Ministries of Finance and of Regional Development and Public Works jointly determine the allocation to the housing reconstruction fund.

**Croatia.** The Law on Socially Stimulated Housing Construction is adopted, as a legal framework for providing of housing for socially vulnerable population and low and medium income population, according to the model in which housing construction is financed with the participation of the government, local authorities, citizens and banks finding their interest in this business. In this way the financing model is closed, with real sources, at the same time making the cost to the final user acceptable from the standpoint of average purchasing power of the population. Until passing of this Law, the Ministry of Public Works, Reconstruction and Construction initiated this year the first phase of the Programme of Socially Stimulated Housing construction which would, within the existing legislative and financial framework, make apartment purchase affordable to buyers with medium incomes, who cannot solve their housing problems by themselves due to expensive bank loans. According to the Programme, the apartment is purchased with obligatory participation of the purchaser, of 15% of the overall apartment price, with the repayment period of 30+1 years (possible 1 year grace period in the first year), the average interest rate of 4%, and at the maximum price of 850 USD per sq.m. of net area (NA). The participants in providing the funds are the local authorities with the price of land and municipal infrastructure up to USD 200/sq.m. NA, the central government in the amount up to USD 170/sq.m. NA, and banks up to USD 300/sq.m. NA. The average monthly installment for a two-bedroom apartment of about 50 sq.m. would be about USD 175 per month.

A World Bank project in **Bulgaria** set up the Housing Reconstruction Fund, to help municipal building/renovation schemes for rented housing for people on low incomes or having difficulty gaining access to housing. The target group of the program was the households whose pre-1990 housing savings were invested in “pyramid” building firms. The Housing Reconstruction Fund receives an annual appropriation of 1.5% from the national budget. Ten-year loan granted at a fixed rate of 16-17%<sup>20</sup> by the State Savings Bank (which became an ordinary bank on 1.1.2000). It continues to be the only source of housing loans for private households. Loan amount was under 70% of the total amount of the planned investment. Because of low household incomes, in 1994, only 5 557 households concluded housing loan agreements with the Savings Bank<sup>21</sup>.

84. It is very difficult to evaluate the housing subsidy programs in the South-Easter Europe. There are no systematic information on the programs, not even known the size of the subsidies. In Europe the housing subsidies account for 1-2 % of the GDP. In Hungary and Poland the direct and indirect subsidies have reached 1,3 % of the GDP. We can suppose the same size of the subsidies in the region, which is spent without any information on the performance.

85. One of the problems of the interest rate subsidies could be that state housing agencies Fund and commercial banks are mostly overlapping, and frequently individual home financings will be coo-financed between both. The Fund should seek the same levels of credit risk protection as commercial banks, and does not operate as an enhancer of private lending, as comparable public housing finance institutions do in Western Europe and North America. (Dübel, Marstellinger, 2001) The public sector could compete with the private sector, and could overcrowd it.

86. Housing subsidy program cannot bridge the affordability gap. The eligibility criteria either too wide, so the “demand” cannot be satisfied, or the income constrains select only the middle class people. The conclusion is that without efficient housing finance subsidy program cannot be efficient.

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<sup>20</sup> Council of Europe, Making South-eastern Europe a region of social cohesion: Housing Problem in South-eastern Europe-Bulgaria, SEER/Housing (2000) 3, Strasbourg

<sup>21</sup> Economic Commission for Europe (1996), Country profiles on the housing sector: Bulgaria, Geneva

## **G. Conclusion: proposals, suggestions**

The paper has given a description and evaluation of the housing finance system in South-Eastern Europe countries. Reviewing the literature and the information provided by the working group we can draw some general conclusions.

### **1. Housing and macroeconomic performance**

87. Almost every observer concludes that macroeconomic strategy is a key element of an efficient housing finance system. It is an illusion that housing policy could substitute the macroeconomic stability, or housing policy in itself can be an “agent” of the macroeconomic stability through deep subsidies. Early housing reform concepts in the region aimed to improve housing situation proposing more fiscal burden on the government, but they remained on paper. There are arguments saying that the future of housing lending depends on the factors (macro economic changes, real estate market, subsidies) that shape the demand side. With the growth in real incomes, the willingness and ability of households to save are expected to increase. Housing sector can be an “agent” of the transition not through demanding more subsidies, but through **initiating structural changes**. There are two interrelated areas of changes: operation and maintenance of the sector, and the housing market (transactions, construction, etc.)

88. More specific element of the macroeconomic stability is the balanced “housing economy”. The revenues and expenditures of the housing sector should be balanced with a fiscal burden manageable by the government. The hidden, off-budget subsidies should vanish. This is a conclusion, which has not been realized in many of the proposed strategies. The problems of arrears in the housing related public sector should be localized with the help of a targeted housing allowance system. This problem is aggravated by the fact that more major sectoral reforms have to be undertaken in the energy and other public service sector. This will lead to an adjustment of prices to economic levels. Given the existing structure of household incomes and spending, an efficient housing allowance system is needed to protect the poor from unaffordable price increases.

### **2. Toward a new housing policy**

89. The other general conclusion of the research on this area is that no efficient housing finance can be built around a deteriorating housing sector, because the financial sector will “price” the risk so high that housing finance will be unaffordable by the majority of the household sector. This would lead to a situation where the “rich” do not need financing, and the “poor” could not afford it. Consequently there would not be a demand for loans. This is and this will be the most important constraint for the development of the housing finance sector. Other factors, like the “adverse attitude” towards taking loans are less important and more easily manageable. So housing finance strategy should focus on the factors, which make financing expensive, management of the risk and competition are two decisive elements.

90. The key issue is the affordability (to access housing), which can be measured by the house price-income ratio. The housing policy should accept the fact of reality that the gap between the incomes and housing prices (or construction cost) cannot be bridged by subsidies for the whole society. The aim should be that the majority of the society would finance their housing needs by savings (intergeneration savings included) and by credit provided through the financial sector with no or shallow subsidies. The strategic question is how to reach this aim, what kind of housing policy would lead to this system.

91. Targeting the subsidies is a widely accepted **principle** in housing policy reforms. Nevertheless the practice is more complicated, even the developed countries struggle to redesign their subsidy system. The experience of the countries in transition is that the housing subsidy system can be restructured gradually, and in the process certain compromises should be taken to have a feasible system. The ideal solution would be that subsidies are targeted to the low-income people, but this means, that middle-class will be frustrated in access to mortgage finance, government programs are soon withdrawn from targeted lower-income groups. The advice is that governments should not give up, and through reaching macrostability with a sustainable mortgage finance industry in place, they can push the mortgage affordability downwards with subsidies. (Renaud, 1999).92. Housing policies in the reality depart from the ideal principles, and make compromises. Some of them distort the financial system, some of them contain reasonable compromises. One compromise is that subsidies should be used for setting up innovative institutions, new legislation, and new organizations, which could serve as agents of structural changes. The other compromise is that subsidies can be directed to the better off groups temporarily to make a program feasible and operational. It is almost impossible to verify these statements as there is no information about the effect of the subsidy programs.

93. Housing policy should be monitored, and subsidy programs can be designed to build up systematic knowledge about the behavioral effect of certain subsidies. There is a need for a well-organized government agency with the mandate to take the lead on the cooperation of the various agencies to agree upon and achieve the housing policy goals. The policy maker underestimates the cost and even the importance of the information gathering, but according to the western experience it could be as high as 0,5 % of the GDP. (Keith, et al, 2000)

94. Urgent, war and forced migration related housing programs should focus on the immediate aims and – probably – cannot contribute to the long-term housing system. It seems to be an illusion to design urgent housing projects with an expectation to serve as a basis of the future housing policy.

95. *It would be important to reconsider the role of state financial agencies.* Government-influenced banks may fix loan rates “too low” to be commercially attractive, and then ration access to minimize the damage. Borrowers may perceive that such banks are not free to aggressively pursue loan recovery. At the opposite extreme, consolidation of the monopoly position of the former state savings bank may permit charging rates that are “too high,” similarly stunting the market. (Diamond, 1999)

96. Well functioning real estate market, with a reduced house-price-to-income ratio and enhancing the supply of rental units. The latter is an important fringe condition for making foreclosure work in practice.

### **3. Building a legal and financial background of the housing finance**

97. In an improving macroeconomic situation, the lack of an adequate institutional network will cause real problems and delay the development of the housing finance system. In Visegrad countries most of the housing finance institution and legal background are basically in place, but even today housing finance is in trouble as illustrated by the ratio of outstanding loan to GDP, loan to value ration on the market transactions, etc. Despite this fact, the creation of a solid institutional and legal background for the housing finance system is necessary.

98. Legal changes should be introduced if the technical and political feasibility of the proposals are given (or being developed) for the enforcement of the laws. Modification of the housing sector related laws have to be supported by subsidy programs. It is inevitable to improve the land register system and procedures by completing recording of all real estates and apartments, prompt registration procedures; to review foreclosure procedures, with regard to duration of proceedings and eviction and thus carryover costs.

99. On the demand side, a special program is needed to increase the creditworthiness of the new actors: developers, construction companies and condominiums. These institutions would be a stable expansion of the market for credit.

100. The basic institution of the banking sector is already in place in most of the countries. The willingness of the lenders to enter into the housing finance will depend on the presence of an adequate legal and financial infrastructure for mortgage finance. In the long run, if the legal background is in place the banks will work out their way towards the housing sector. They have to make money through providing loans for the housing market actors. An intensifying competition, lower costs of resources for banks as well as smaller credit and interest risks may enhance housing finance activities of banks. Banks are forced to pay more attention to the retail lending market when easy money cannot be made any other way and they become intent on pursuing long-term growth strategies.

101. In improving the housing finance system, the funding issue will be more important. A steady increase in the number of current accounts that are the cheapest resource of long-term loans helps to avoid the need to refinance long-term loans and reinvest long-term resources, which is risky in an environment of unforeseeable inflation rate and real interest rates. In a more developed stage, domestic savings and investment have to increase substantially to prepare the economy for responding to the increased demand, and some sort of capital market solution would be needed.

102. The role of bauparkasse (contract savings) banks needs to be reconsidered. Experience so far has not supported or justified the subsidy given to these institutions. In the Czech Republic, Slovakia, and Hungary, it is possible to evaluate the performance of these banks. It would be important to have a critical evaluation based on data, before other countries in the region give the savings banks substantial part of the housing subsidy.

103. The housing wealth in a developed market can be used to help the “housing rich-income poor” groups, when these groups can have access to loans issued against their property. In principle reverse annuity mortgages -- despite problems of adverse selection -- might be one of the most cost-effective ways of dealing with this dimension of poverty.

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