Housing Finance at the Millennium: An Assessment of Achievements and Outstanding Issues

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THE EVOLUTION OF HOUSING FINANCE IN POLAND

Poland's housing finance system is now in the second stage of transition and is about to enter the third. The first stage began in 1991, with assistance provided by Polish and international institutions, including the U.S. Agency for International Development. This assistance was especially directed at capacity building: institutional capacity building—such as the Mortgage Fund and the establishment of PAMBank (currently GE Bank Mieszkanioowy), human capacity building via extensive training programs, and legal and administrative capacity building instituted through both decentralization and passage of the main laws that would henceforth govern housing and housing finance. The end of the first stage is perhaps best marked by the end of subsidized lending by PKO BP and the initiation of lending by PBK, both in 1996.

The success of this first stage also owes a great deal to the larger economic, social, and institutional transitions being undertaken in Poland at the same time. Among the notable factors that assisted housing finance to mature were:

- Reform of the banking sector, which propelled the overall financial sector toward a modern, market-based, competitive system.
- Macroeconomic policies, which led not only to falling inflation but also, importantly, to a decline in inflation which proceeded on a steady course.
- Competition, which has been crucial. When PKO BP ended subsidized lending, competition from private and foreign banks could emerge; three of the universal banks (BISE, Pekao S.A./PBG, PBK) and PAMBank quickly seized this opportunity.
- DIMs (dual-index mortgages), which proved to be successful in Poland's environment of falling rates, and considerably enhanced the affordability of mortgage loans.
- Establishment of the Mortgage Fund, a refinancing institution supported by international donors as well as the government of Poland, which boosted liquidity by refinancing eligible DIM loans. Even more important perhaps, the fund enhanced the technical development of both construction and residential mortgage finance.

The second stage of evolution—1996 through mid-1999—has witnessed the emergence of the modern system. The millennium will find Poland's universal banks with a steadily increasing portfolio in mortgage finance. Although about 30 banks now offer mortgage finance, five or six dominate the market, with portfolios that include a variety of mortgage products and terms. Poland has continued to support more affordable lending with a variety of DIM products. Its unique experience in this regard probably offers the most successful example worldwide. Poland has also sustained its efforts to conquer inflation, which moved into the single digits during 1999 and made zloty-based consumer lending relatively affordable. And, since its gross domestic product reversed its downward spiral in 1993, Poland has maintained the highest
average rate of economic growth in Central and Eastern Europe.

At the dawn of the new millennium, Poland's housing finance system is on the cusp of a third transition. Privatization of state banks, mergers, and accelerated entry of major foreign banks and capital have changed the face of the banking sector. The Mortgage Banking Law, in particular, has re-opened the door to the type of funding that was integral to Poland's pre-war system of housing finance. As more of Poland's new mortgage banks begin operation in 2000, Poland will emerge with a dual funding system, deposits as well as capital-market based. Unlike the Czech Republic and Hungary, for example, where mortgage banking has been in operation for several years, Poland has only just recently granted three mortgage bank licenses to-date and only two of the banks have actually begun conducting business. Thus, relative to the situation in some other Central and Eastern European countries, Poland's universal banks have gathered considerable market momentum.

Poland is also consolidating its progress on a wide variety of housing finance issues. These include continued improvement of the legal and administrative framework, development of a regulatory and supervisory system specific to housing finance, streamlining of existing mortgage products, and strengthening of the peripheral institutions and organizations necessary for an effective real estate market (among which are a strong bankers association with a specialized committee on housing finance, a credit bureau, and associations of home builders, realtors, and appraisers). Both continue reform of the banking sector and implementation of the supervision regime for housing finance will contribute to the stability of the housing finance environment.

Government policies toward housing are also in the midst of major reform. Subsidy policies are being redesigned to be consistent with the government's tax reform and other proposals, including more effective targeting. Government has offered support to both residential and rental sectors and has sought to design more targeted and transparent subsidies. Homeownership is to be supported by either a mortgage interest deduction or an interest buy-down, directed at specific income groups in need of assistance. Unlike many of its neighbors in Central and Eastern Europe, Poland's contract savings system is being developed according to internal specifications rather than wholesale adoption of the Bauspar model.

Problems and questions certainly remain. New construction has not yet regained pre-transition levels. Interest rate spreads, although they may be slowly falling, remain especially high. Questions include whether universal and mortgage banks will be able to compete on a level playing field and whether, especially in the short term, mortgage banks will be able to raise money at competitive rates. Similarly, it remains to be seen whether the long-term funds for housing finance will be secured from the capital market solely through mortgage bonds, or whether additional debt instruments and/or systems of liquidity, refinancing, or securitization will come into play. Finally, in order to properly measure (and therefore price) various elements of risk inherent in any system of housing finance, the information systems of the banks and a number of public agencies must be enhanced to provide the necessary information to potential investors as well as others with a legitimate need for it. Such improvements should both reduce interest rates and increase the use of housing finance.

A SCORECARD FOR POLAND: MAJOR ACHIEVEMENTS IN HOUSING FINANCE

Poland can justifiably pride itself not only on its economic growth and relative stability but also, especially in recent years, on its thoughtfully developed approach to housing and housing finance policy. A quantitative and qualitative assessment of Poland's current system follows.

A Competitive Institutional Structure

Poland has developed a competitive, market-driven system of housing finance in less than four years. While PKO BP remains dominant, in three years its position in the market has dropped from being a monoplist to facing real competition. Other banks now hold about 22% of the loans and 37% of the total portfolio value. Furthermore, the rate of increase in the volume of lending by the other universal banks is growing quickly. Of the competition, two banks each hold about 7% of the total portfolio in PLN (new Polish zlotys); the share of the next five banks combined is about 14% (with shares ranging from 2% to 4%); the share of all the other lenders together is about 8%.

Poland's main concern now may be, not lack of competition, but rather an "over-banked" financial sector. Poland's banking sector has experienced a major thrust toward consolidation and the dominance of new, larger institutions—through mergers, acquisitions, privatization, and continued entry of foreign partners. Poland boasts six of the 11 largest bank sales to foreign banks to take place in Eastern Europe. In any event, the housing finance sector, like the banking sector overall, appears to have too many players to be sustainable in the long run. Thus, more consolidation is to be expected.

In addition to becoming more competitive, Poland's housing finance portfolio has grown quite rapidly since 1996 (as discussed further below). The holdings of those lenders with the majority of the portfolio now represent a reasonably substantial share of their total assets. Considered across the entire banking system, however, housing
finance still represents only a small portion of total assets. Between the end of 1996 and mid-1999, consumer lending and mortgage lending have both grown as shares of total assets, but the mortgage portfolio has grown more rapidly, now accounting for just over 1% of the total. If demand and stability conditions remain favorable, this percentage is likely to increase fairly rapidly, perhaps even reaching 10% of total assets, and a higher proportion of consumer lending, in the near future.\(^5\)

**Mortgage Lending by the Universal Banks.** Figure 1 provides estimates of the total mortgage portfolio of all banks responding to the survey by the Cracow Real Estate Institute/Polish Banks Association.\(^5\) These estimates include mortgage lending (loans for purchase of a dwelling), and developer credits for residential housing and for commercial construction.\(^7\) Total portfolio growth from the end of 1996 has accelerated rapidly, increasing two and one half times during 1999. Comparing these rates with the rate of inflation during comparable time periods makes it clear that substantial real gains have been made (inflation was 19.9% in 1996, 14.9% during 1997, 11.8% in 1998, and 9.8% in 1999). The number of loans has also increased, though somewhat more slowly, increasing the value of the average loan in nominal terms but not in real terms. Factors cited for the increase in the volume of lending include a decrease in interest rates and also the expected elimination of the personal income tax deduction for home construction.

Figure 2 divides the housing portfolio by type of credit. Mortgage credit dominates, accounting for over 81% of housing lending; credits to developers stand at 15.2% and commercial credits at 3.5% of the total. Different types of credit have grown at considerably different rates. Mortgage credits have increased nearly five-fold between the end of 1997 and the end of 1999, with residential credits showing the fastest growth. Reportedly, the commercial market is somewhat overbuilt, especially in Warsaw, and some rents have actually fallen. (Warsaw now has considerably more office space per capita than either Prague or Budapest.\(^5\))

In addition, at the end of 1999, households with contract savings accounts could begin to take out low interest loans. Pekao has already announced that 14,000 contract holders will be eligible to take out a loan; it expects 60% of the households to do so. Thus, growth in mortgage credits will receive a new boost from 2000 onwards.

With no precedents for development of market-based housing finance in transition countries, it is difficult to assess whether the increase in mortgage lending (from a very small base, of course) has been "rapid" or not, especially for mortgage credits for home purchase. One relevant comparison is the increase in mortgage lending compared with the increase in total due to private persons—a broad measure of total consumer lending. Figure 3 makes this comparison. Increases

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**Figure 1.** Total Mortgage Finance Credits Outstanding

<table>
<thead>
<tr>
<th>Month &amp; Year</th>
<th>Total (PLN Million)</th>
<th>Number of Loans (000s)</th>
<th>Average Loan (000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/96</td>
<td>663.0</td>
<td>21.5</td>
<td>30.9</td>
</tr>
<tr>
<td>12/97</td>
<td>1502.2</td>
<td>42.5</td>
<td>35.3</td>
</tr>
<tr>
<td>12/98</td>
<td>2903.6</td>
<td>73.5</td>
<td>39.5</td>
</tr>
<tr>
<td>6/99</td>
<td>3952.8</td>
<td>96.0</td>
<td>41.2</td>
</tr>
<tr>
<td>12/99</td>
<td>7520.4</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Source: Urban Institute Concern/Polish Banks Association Bank Survey, Cracow Real Estate Institute estimates, and National Bank of Poland

**Figure 2.** Total Mortgage Finance Portfolio by Type of Credit

- Total Mortgage Lending (breakdown not available)
- Developer Housing Credits
- Individuals
- Mortgage Credits: Home Purchase
- Commercial Development Credits
- Business Entities

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**HOUSING FINANCE INTERNATIONAL**
in mortgage lending for home purchase have outpaced those of private credit overall by a considerable margin: mortgage finance as a share of total consumer lending, which was only 5.7% at the end of 1996, had risen to nearly 14% by June 1999.

In addition, mortgage lending use in Poland, while still fairly small in comparison with the U.S. and most of Europe, is higher than that in either Hungary or the Czech Republic. Estimates indicate that about 20% of purchases of new homes are made with mortgage loans (we do not have estimates of loan usage for purchases of existing homes because there are not adequate estimates of the number of transactions). Although it is not clear what level of utilization should have been expected at this stage in the transition process, Poland's banks are leading the region.\(^9\)

A major shift in the institutional structure of lending in Poland may occur in the third stage of the sector's evolution, as Poland's new mortgage banks begin operation. How many of the universal banks will continue to compete, or whether those universal banks wishing to remain serious players in housing finance will establish mortgage banks, is not clear. What is clear is that the millennium will witness one of the most important steps in the institutional evolution of housing finance.\(^10\)

**Figure 3.** Increases in Total Consumer Credit and Mortgage Lending

<table>
<thead>
<tr>
<th>Period</th>
<th>Increase in Total Due to Consumers</th>
<th>Increase in Mortgage Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/97-12/98</td>
<td>30%</td>
<td>82%</td>
</tr>
<tr>
<td>12/97-06/99</td>
<td>54%</td>
<td>147%</td>
</tr>
</tbody>
</table>

**Diversified Loan Products and Terms**

Key features of the residential mortgage portfolio for the major lenders include:

- **Type of Loan Product.** DIMs (dual-index mortgages) dominate the overall portfolio. Roughly 40% of PKO BP's portfolio is represented by DIMs, which also make up about 80% of BISE's and 25% of Pekao S.A./PBG's portfolio. The remainder of PKO BP's residential loans are DPMs (deferred payment mortgages, also an indexed product). Most of the balance is made up of variable interest rate products. Among the major lenders, only PAMBank offers fixed rate loans (US$ denominated).

- **Poland is unique in the world of housing finance in the dominant role played by DIMs. To our knowledge, no other nation has been as successful with DIMs as has Poland. Mexico has longer experience and heavier dependency on the DIM, but Poland has avoided the types of crises that DIMs risky.** DIMs are a highly technical loan product, and can, indeed, be extremely risky. Poland has benefited from a number of factors that together have contributed to the DIM's success to date: (1) a steady fall in both the level and variability of inflation; (2) training in the development and use of DIMs, especially through the Mortgage Bank; and (3) relatively conservative general principles regarding DIM characteristics, including Mortgage Fund eligibility rules for refinancing.

- **Currency.** The vast majority of loans are zloty-denominated. However, PAMBank's loans include USD and BSE offers in French francs as well as zlotys. Smaller mortgage lenders offer Deutsche marks and/or Austrian shillings (such as Bank Creditanstalt), or DPM (BPH, Creditanstalt, Investbank, and LG Petro Bank).

- **Interest Rates.** Two features of the interest rates on variable loans are particularly noteworthy: First, rates have steadily declined, especially during 1999. Second, depending on the time period, the rates offered across the major competitors have varied fairly widely. (See also the analysis of lending rates relative to other market parameters, below.)

- **Maturity.** Loan maturities range from 5 to 20 years. "Typical" maturity is 10 to 15 years. Although prepayments were fairly common two or three years ago (perhaps as much as 10% of the portfolio as cited by one bank), the rate has now fallen. There are several reasons: some banks charge a prepayment penalty and interest rates are also lower.

- **Maximum and Typical LTVs.** Typical LTVs—about 40% to 60%—are much less than the maximum stated in most banks' policies, reflecting the conservatism of both Polish lenders and borrowers. (In comparison, typical LTVs in the U.S. are 75% to 100%; many special affordability programs provide LTVs of 90% to 100%. In some cases, a portion of the LTV—the highest 15 or 20 percentage points—carries default insurance.)

- **Ratio of Monthly Payment to Income.** The ratio of the loan payment to a borrower's monthly income—the so-called effort ratio—varies widely, generally ranging between 17% and 40%.

**Poland's Rate Structure: Efficiency and Affordability**

This section compares time trends in lending rates, deposit rates, inflation, and one-year government paper in order to assess the efficiency and affordability of Poland's rate structure. As discussed further below, high real lending rates and exceptionally
large spreads are problems that Polish banks will need to continue to address in the next few years. Relevant questions include:

- How have the changes in mortgage lending rates corresponded with inflation?
- How do lending rates compare with those for government debt?
- How do lending rates compare with the cost of funds for Poland's banks?
- How do Poland's interest rate spreads compare with those of Europe?

Figure 4 provides basic data on interest rates and inflation; the mortgage lending rate shown in the table is the weighted average lending rate on variable rate mortgages for the five major lenders. Other rates could be used as desired.

It is, of course, crucial to housing finance affordability that rates continue to fall. The steady fall in inflation since 1996 is impressive and appears to be continuing. Indeed, a breakthrough appears to have been achieved during 1999, as inflation fell to the single digits. The issue is whether interest rates have fallen accordingly. In particular:

- Have lending rates, Treasury-bill rates, and WIBOR all followed the decline in inflation in comparable magnitude?
- Has the margin between deposit rates and lending rates begun to fall to acceptable levels, relative to international standards of operation?

The answer to whether the various interest rates are falling in rough correspondence with inflation (and with each other) is: not quite. Between January 1997 and July 1999, inflation fell by 11.8 percentage points (a 65% drop). However, the weighted average lending rate fell by 9 percentage points (a 35.3% drop); and the T-bill rate—which fluctuated more than other rates during this period—saw a net drop of 7.68 percentage points (a 38.6% drop). To keep strict corre-
spondence with the drop in inflation, the mortgage lending rate would have had to fall at a somewhat higher rate. It did, however, follow the drop in T-bill rates in relative magnitude.

Interest Rate Spreads in the Banking Sector Overall. The efficiency of the banking sector can be usefully addressed by an assessment of the gap between lending rates and deposit rates. A recent assessment of margins and costs in the Polish banking sector has documented the very large spreads, relative to Europe, between average rates paid to deposit holders and the average return from lending. The average interest margin of Polish banks was 6.2% in 1996, for example, compared with 0.7% to 0.9% in Switzerland, 1.0% to 1.2% in Germany, 1.1% to 1.8% in France, and 2.3% to 4.7% in Greece. This study, carried out by Goldman Sachs, indicates that the exceptionally high spread in Poland is a function of both high operating costs and high reserve requirements. Banks within Poland vary considerably in their spreads, with the larger, internationally oriented banks having the lowest spreads. The largest spreads occur in small banks, which operate in local or niche markets. Goldman Sachs suggests that if spreads were to fall by a reasonable amount from a market perspective—2.9 percentage points on average, according to their calculations—most Polish banks would start to suffer losses. To survive in that case, they would have to reduce operating costs and significantly increase returns.

As Poland’s housing finance system matures, continues to be subject to the pressures of competition, and begins to reflect reductions in operating costs (no doubt helped by consolidation, privatization and foreign partners), efficiency should be enhanced and both of these gaps should shrink more rapidly. Recent declines in both mortgage lending rates and the various spreads indicate that competitive pressures have created a responsive financial environment in housing finance. However, the gaps remain too large for effective housing finance in Poland, especially in a long-term environment that will be increasingly subject to European Union and other outside competition.

Affordability of Housing

Housing affordability is a complicated function of the inter-relationships among income, construction costs, swings in market prices, mortgage rates, deposit rates and so forth. Is housing becoming more affordable in Poland? In other words, as compared with several years ago, can consumers (assuming the same level of real income and facing the same effort (payment-to-income ratio) afford a larger loan because rates have fallen? Will this larger loan buy more housing than previously? Or alternatively, has real income increased faster than real interest rates and real construction and purchase costs?

The tentative answer is that housing affordability is slowly improving for consumers:

- Income, on average, is increasing faster than prices: real average monthly wages increased by 5.5% in 1996, 5.9% in 1997, and 3.7% in 1998.
- Construction prices are increasing at roughly the same rate as inflation. The increase for 1998, for example, was 12.9% as compared with 11.8% for the consumer price index. In 1997, however, the construction cost index increased by 14.2%, while inflation stood at 14.9%. Thus, increases in real wages as compared to increases in (real) construction costs have shown a gain.
- Real lending rates have shown a small downward trend since mid-1998 (although the gap remains large). So affordability, as assessed using a constant monthly payment, should be increasing slightly.
- The maximum deposit rate available to consumers appears to be gaining on the rate at which they must borrow for a mortgage.

Do these improvements mean that the vast majority of households can afford to purchase a home? No, but the situation is better than generally recognized and certainly appears to have improved in the first six months of 1999. Income relative to construction costs still remains low in Poland. However, using a DFF loan, or a conventional loan, with mortgage rates now at 16%, purchasing a modest apartment with a mortgage loan and a down payment of 25% or 30% is certainly feasible for households with moderately high incomes. If lending rates continue to fall, consumers will begin to see major improvements in affordability.

The missing information needed to complete the affordability picture is the actual sales price of housing (per square meters) in different locales. Although there is no nationwide index for sales prices in Poland (in the U.S. for example, the median sales price is published regularly to provide comparisons over time), the Housing Research Institute (HRI) regularly conducts a sample survey of 23 gminas (local governments), which provides a good overview of sales prices for small, medium, and large cities. The sample includes large gminas (over 100,000 persons), medium (25,000 to 100,000) and small gminas (less than 25,000). Prices are given for a range of situations: the lowest cited in the sample, the most often cited (the mode) and the highest (these are asking prices for apartments in multifamily units).

Generalizations from these figures about either averages or trends are hazardous, however, as house prices vary tremendously between urban and rural areas, from city to city, and from large cities to small.
POLAND

Figure 5. Household Affordability in 1998 (Total Square Meters Able to Be Purchased With a DIM Loan)\(^6\)

We can address the affordability of home purchase with a mortgage loan, however, by choosing some "representative" price; we have picked PLN 2000 per square meters, which is the "lowest" price for Warsaw in the HRI data, but close to (or exceeding) the highest in Lublin, Lodz, and Torun, and much in excess of the highest in the majority of medium and smaller cities in the sample. Figure 5 indicates the number of square meters that an "average" household in each of ten income categories (deciles) is able to purchase with a DIM loan, a 30% down payment, and an effort ratio (payment to income ratio) of 38% (among the highest in Poland).

Using these assumptions, households in the sixth income group, for example, are able to purchase an apartment of 48 square meters, while those in the ninth income group can purchase 80.7 square meters. If we assume a price per square meters of only PLN 1000, we can clearly double the amount of space that can be purchased under our assumptions; thus households in the third group and higher could purchase an adequate unit in smaller cities or in the less expensive neighborhoods of the larger gminas.

Professional Support Organizations

The housing finance sector in Poland receives support from a number of professional organizations—most especially the Polish Banks Association, but also associations of appraisers, builders, and realtors. In addition, peripheral institutions and services—such as the newly formed Credit Bureau and the introduction of mortgage-related insurance products—will further support risk reduction efforts.

The Polish Banks Association (PBA). The PBA is an effective and active professional organization supporting the interests of banking in Poland. In 1997, in response to rapidly increasing interest in housing finance among its members, PBA formed a permanent Housing Committee. Among its activities in assisting the development of housing finance, PBA has lobbied to improve a variety of legal and administrative impediments to housing finance; has sponsored conferences and workshops to address numerous issues including regulation and supervision and appraisal practices; has reached out to similar professional organizations in Central and Eastern Europe, Europe, and the U.S. to develop lines of communication on issues of regional and international interest; and has sought to supply its members with educational material on housing finance from both the U.S. and Europe.

PBA has been an instrumental sponsor of Poland’s new credit bureau, a valuable addition to the housing finance sector (see below). PBA is also working to resolve disagreements over regulatory matters, such as appraisal issues that have arisen between the Federation of Appraisers and Generalny Inspektorat Nadzoru Bankowego (General Inspectorate of Banking Supervision) or GINB. In addition, PBA is involved in developing new mortgage-related products, such as mortgage insurance.

The Credit Bureau. The Polish Banks Association and other organizations have been active for over a year in initiating Poland’s first credit bureau, which opened its doors for business in early 1999. This is an extremely important step for Poland, where banks, appraisers, realtors, and developers have not had a tradition of providing mutually "beneficial" information. This is one aspect of the Soviet legacy, aggravated by the facts that (1) some banks do not, as yet, have information technology systems that make it easy to release aggregate or specific information, and (2) laws on releasing consumer information are particularly strict.
In underwriting mortgage loans, banks should ideally calculate the gross debt ratio—the combined payments a household must make on all its installment debt relative to income. The Polish Credit Bureau is now gaining membership and momentum to ensure that banks share the necessary data, which has not been commonplace. Safeguards and confidentiality systems are being put in place, and one can hope the battle will gradually be won. If banks can underwrite with more confidence about the true value of a household’s circumstances, including its gross debt ratio, then loan-to-value ratios and payment ratios could be made less conservative when circumstances so indicated.

Major achievements include increased competition, effective use of innovative loan products, support to sector development through the Polish Banks Association and other professional organizations, and improvements to public sector housing finance policies. The new millennium will soon see introduction of a capital market funding mechanism through mortgage banks, regulation and supervision procedures tailored to housing finance, and revised housing subsidy policies compatible with increasing use of mortgage finance.

According to The Wall Street Journal Europe, “Poland boasts one of Central Europe’s healthiest banking sectors, with 68 banks among the region’s 247 largest. Increased competition is forcing down margins and encouraging consolidation.” As ranked by assets, Poland boasts four of the largest 10 banks in the region: PKO BP in second place, Pekao S.A. in third, Bank Handlowy w Warszawie in eighth, and BGZ in tenth. In addition, BGK was ranked second in the region with respect to return on assets.

Major hurdles still face Poland’s banks in the millennium, however, according to our analysis. As the volume of mortgage lending grows, the demands on the system for adequate funds, adequate information, and more effective analysis and sharing of risks will inevitably increase.

Two major tasks, in particular, will face Poland’s housing finance system in 2000 and beyond: increasing banking efficiency and increasing housing finance use. Reducing interest rate spreads and real lending rates is crucial to increasing efficiency. This will involve not only consolidating the progress made to-date in the system but also continuing with institutional restructuring, better information systems, further legal and administrative reforms, and other steps already underway to reduce operating costs.

Increasing the use of housing finance is, of course, tied to reducing real rates. But it also requires addressing other barriers, including changing consumer attitudes toward housing; shifting how risks in the system are shared, through a better mix of risk across the banks, the borrower, and third-party credit enhancement; and economy-wide issues involving mobility and government subsidy systems targeted to increase effective housing demand.

Key questions for Poland include:

- What would be an efficient way for the institutional structure of mortgage lending to evolve?
- What should be Poland’s medium-term goals for lending rates and spreads?
- What are key issues in addressing risk (e.g., adequate information systems for quantifying risk and continued legal and administrative reforms)?
- Do the banks bear an unfair share of the risk burden?
- Is housing finance underutilized? What might be the causes?
- Are too few households gaining access to the system?
- Are loan terms unduly conservative (that is, are loan-to-value ratios too low or loan duration too short to assist affordability)?

Increasing Efficiency: Evolving Institutional Structure and Roles

The third stage in Poland’s evolution toward a new institutional structure in housing finance will see additional progress in privatization—with PKO BP scheduled to be privatized in 2001—and the introduction of mortgage banks. The merger and consolida-
tion process will doubtless continue, in efforts to further reduce costs and spreads. This may be not only an internal process but also an external one that looks to Europe and elsewhere. Pekao S.A.'s CEO put it well: "If we want to be a functioning part of Europe, we should accept changes in the market, and be deeply involved in globalization."17

Among Poland's nine largest banks (as measured by their capital), six have applied for a mortgage banking license and a license has been granted to two (BRE and HypoVereinsbank). Other Polish banks, their foreign partners, and other foreign banks are considering application or have already applied. Among the universal banks' major lenders in housing finance, three of the six have applied for a license. Others, however, will continue lending for mortgage finance as universal banks.

Level the Playing Field. Competition in this mixed housing finance environment will be best served by ensuring that both universal and mortgage banks operate on a level playing field. Making this happen requires addressing issues on both sides:

- In the short term, universal banks need fair treatment on issues such as the statutory lien. In the longer term, they will need access to capital market funds via means that might include rejuvenation of the Mortgage Fund, introduction of another type of refinancing facility, and/or development of a legal and administrative structure that would permit securitization.

- Mortgage bonds apparently face a variety of barriers that may make them uncompetitive as sources of funds, such as transfer taxes and limits on their acquisition by potential capital market investors. Our analysis of interest rate spreads (see section "Major Issues in the New Millennium") suggests that spreads will have an important influence on the future success of mortgage bonds. In Europe, mortgage bonds are viewed as very safe debt instruments: the difference between mortgage bond rates and that on government debt is estimated to be about 0.4%. It will be difficult for mortgage banks in Poland to fund themselves effectively until the barriers that make them relatively costly as sources of funds (compared with the low-cost funds available from depositors) are lowered.

Improving Information Systems to Better Assess Risk in Housing Finance: What Kind of Data Should Be Collected and Who Should Collect It?

If Poland is to have a sophisticated, broad, and deep housing finance market, it must have sophisticated, broad, and deep pools of data available to borrowers, lenders, insurers, investors, regulators, and financial and macroeconomic analysts.18

The relative dearth of data in Poland, as in other transition countries, is a major legacy of the Soviet era — either the data were not needed inside the centralized system, or it was not in the interests of the various institutions and individuals to make them public. Thus, for example, until the end of 1995, no aggregate data on mortgage finance were published by the Central Bank or Government Statistical Office. National data measuring investment in housing require revised procedures and definitions.19 The Polish Banks Association receives little or no data on housing finance from its members.20 As noted, some banks still face difficulty in assembling statistics in a central location from the branch offices. Expanded IT platforms will be needed to consolidate the systems involved in recent mergers. It should be noted, however, that Poland is beginning to undergo change in this area. As one example, PKO BP, together with Bank Slaski, has set up an electronic payment center. And, IT development is beginning to take off in some Central and Eastern Europe countries; the Czech Republic leads the way in IT spending per capita, followed by Hungary, Slovakia, and Poland.21

In addition, across the board—in banks, the PBA, and independent research institutions—databases on individual borrowers are needed for analysis of a variety of issues: default risk, prepayment risk, information necessary for the development of credit scoring, forecasts of the demand for housing for marketing and planning purposes, and so forth. Finally, outside the banking system proper but vital to its effective functioning is the need for data on "real" transaction prices and for effective application of the various appraisal methodologies.23

Risks Faced by Mortgage Lenders. A variety of risk-related issues are still not fully dealt with in Poland, resulting in an inadvertently large share of various lending risks being shouldered by the banks. For example, underutilized and time-consuming foreclosure procedures favor the borrower over the bank in case of default; since this increases credit risk, it clearly increases bank costs. Similarly, the statutory lien issue is not yet fully resolved; nor is title registration sufficiently rapid or accessible. Such factors have forced banks to develop short-term insurance policies to address operations risk, increasing costs for banks and borrowers accordingly. Mortgage insurance, that is, credit or default insurance, may be a useful product when the system is more fully developed. Other third-party credit enhancements should also eventually enter the system. Meanwhile, however, banks continue to bear much of the risks and their costs, some or all of which are passed on to borrowers through higher lending rates, variable rate mortgage products, lower deposit rates, and/or lower loan-to-value ratios.

HOUSING FINANCE INTERNATIONAL
Factors Influencing Housing Finance Utilization in Transition Countries

The relative role of mortgage credit in the Polish economy has exceeded that in Hungary and the Czech Republic, as noted. Estimates suggest that perhaps 20% of new home purchasers utilize a mortgage loan in Poland. However, total private sector lending in Poland is relatively low compared to other countries in the region—just over 20% of gross domestic product in 1996, compared with about 25% for Hungary, over 40% for Slovakia, and about 65% in the Czech Republic. Thus, the following issues should be considered:

- Is this the level of demand for mortgage credit that should be expected at this time?
- What determinants distinguish the demand for housing and the demand for mortgage credit?
- Are consumers' energies and funds being concentrated on consumer durables or other items instead of housing? If so, why?

These questions are very difficult to answer for Poland (and also for other transition countries). Not only are there insufficient data for analysis but also, as noted, it is not clear what should be expected in the transition process. With which countries should Poland be compared in judging whether utilization is "low," and at what point in the evolution of their mortgage finance sectors? What can be expected as the economy emerges fully from controls and price distortions?

The levels of demand for housing and for mortgage credit in the U.S. and in Western Europe may hold little current relevance for Poland and other transition countries for many reasons. Obviously differentiating factors include differences in income levels, real interest rates, the relative price of housing and other goods, the ratio of the price of housing to income, and expectations regarding local and/or regional political and employment stability. But if we attempt to abstract from these—and make the hypothetical assumption that we are comparing selected households in these countries with similar incomes and preferences—what other factors might explain remaining differences in demand?

The fundamental problem is a gap between potential demand and effective demand. This is aggravated by differences between the variables that affect demand for housing and those that affect demand for credit. In combination, the "promise" of housing under central planning, extensive state housing production, the remuneration of households to a substantial extent via in-kind transfers, and distortions in the pricing systems (whether of housing, interest rates, or consumer goods) have left Poland and the other transition countries with very significant barriers in the way of realizing their potential demand for housing.

Problems of inadequate effective demand can result from policy failures on both the demand and supply sides of the housing market. For example, households occupying heavily subsidized housing—who would, with smaller or no subsidies, consider moving to another dwelling or even another city—may have little or no incentive to move as long as subsidies persist. This is now the situation with communal housing in Poland. Parallels exist with regard to mortgage credit. If the possibility of government subsidies exists for a household, even if it must wait for years to take advantage of the subsidy, that household may be reluctant to seek credit at market rates of interest.

In sum, "non-income-related" constraints to demand for mortgage credit might include:

- Mobility constraints, such as lack of rental housing permitting smooth relocation.
- Limits on tenure choice—again, a lack of rental housing or dwellings suitable for purchase.
- Other supply constraints on housing types and locations.
- Liquidity constraints—that is, relative inability to secure a sufficient down payment, especially since much of income was in-kind under the old system, as noted, and households have not had a lengthy opportunity to accumulate savings under the new system.
- LTV (loan-to-value) constraints imposed by lenders who must bear a larger portion of the risk than comparable lenders supported by a better legal and administrative framework.
- High transaction fees.
- High real mortgage lending rates combined with wide spreads over deposit rates.
- Expectations and attitudes to indebtedness (by households and lenders both).
- Expectations and attitudes to the cost of housing relative to other goods (especially consumer durables) and to income.

CONCLUSIONS

Poland's housing finance system is likely to remain under-used and over-priced until reduced operating costs, improved recourse to long-term funds, continued legal and administrative reform, better information with which to address risk, and better sharing of risk, allows both a fall in real rates and a more concerted approach—on the part of
banks, government, and borrowers alike—to market responsiveness and affordability.

Reducing real rates. To some extent, real rates will come down naturally as both the market and competition mature. The average return on assets in Central Europe’s best banks is around 1.4%, down 1.1 percentage points from the previous year. This is only 1 percentage point higher than the Western European average of 0.45%. Nevertheless, concerted action not only by individual banks, but also by the industry as a whole, the supporting professional organizations, and government is certainly required to help the process along.

Spreads are bound to fall as competition increases, continued consolidation absorbs the smaller and less efficient banks into larger units, and increased investment and foreign partner expertise helps streamline operations. All these will exert downward pressure on costs. In the U.S., for example, competition and demand have pushed the mortgage business into a high-volume, low-margin existence. Some aspects of the mortgage lending process can be "money-losers"—origin, for example—with net returns made positive through servicing or even just cross-selling.

But, as noted, one must wonder whether Poland is "over-banked" in the medium term, given the large number of banks already in the sector, some of which are quite small, and the imminent entrance of mortgage banks. Hungary too, for example, is considered overbanked, with over 40 banks serving 10 million people. In this era of mergers and foreign partners, more consolidation in Polish housing finance is likely. In addition, the larger banks are already introducing better technology and systems management (e-banking being one of the latest pushes), which will also push down spreads.

Additional action is needed on the part of the banks, the industry as a whole, and the government, however, to bring about systemic changes and reduce risk in the system. We have noted many aspects of reducing risks and costs; in particular:

- Improved databases and analyses, by banks and the industry.
- Improved data for appraisal and valuation.
- Continued attention to reducing legal and administrative barriers, in order to both reduce and reallocate risk.
- Government decisions on risk weighting and investment rules for mortgage bonds, development of updated Inspection Manuals that give trends over time, and public reporting of key indicators on mortgage finance.

Databases on individual borrowers are also needed for analysis of a variety of issues we have already noted, including default risk, prepayment risk, preparations for introduction of credit scoring, and forecasts of the demand for housing for marketing and planning purposes.

Outside the banking system proper, but vital to its effective functioning, are data requirements for recording "real" transaction prices and effective application of the various appraisal methodologies. LTVs are currently low in Poland as compared with developed markets. Given Poland’s risk profile, this is a rational response on the part of banks. Better appraisal data and more adequate valuation of collateral are needed to give banks a better picture of value. Only then will they feel comfortable about increasing LTVs and reducing spreads.

Difficulties involved in foreclosure, the statutory lien, registration and titling, and so forth, make it inevitable that banks bear much of the risk in lending and have had to develop short-term specialized insurance products to protect themselves. Even though mortgage default insurance and other forms of third-party credit enhancement will assist in sharing risk across the system, until there is better relief from the risks imposed on the banks, margins will necessarily remain high.

Increased use of mortgage lending. Greater use of housing finance will come about as incomes rise, real lending rates fall, and banks’ improved risk positions allow higher LTVs. As noted, however, structural factors must also be addressed. Lack of a vigorous rental market, which will not come into being until rent control is lifted, reduces housing mobility. Other supply and tenure choice constraints likewise limit home purchase.

As long as the economy continues to grow and remains stable, both banks and consumers are bound to change their attitudes about indebtedness. The macroeconomic impacts of increases in bank efficiency and consumers’ willingness to assist their housing needs through mortgage finance will progressively unleash potential housing demand in the future; provide leverage to the housing market and to new construction; and thereby let the economy reap the full benefit of this engine of growth. Poland has made an exemplary start.

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NOTES

1 During this period, assistance was provided to housing finance by USAID (U.S. Agency for International Development), the World Bank, the EBRD, and the British Know-How Fund. See Michael Lea for a compendium of assistance by USAID.

2 Licenses have been granted to Rheinhyposbre, HypoVereinsbank, and Pekao Bank Hipoteczny. Four others are awaiting a decision on their applications: Citibank, Bank Slaski, PKO BP, and WBK. Bank Gospodarstwa Krajowego SA has also announced its intention to apply for a license.

3 It must be noted, however, that the tax reforms proposed during 1999 are now in question, as is the stability of the governing coalition. It is not clear, therefore, to what extent changes to the housing subsidy system will be made.

4 Much of the data cited here stems from a survey of banks in Poland carried out in August and September of 1999 by the Czescow Real Estate Institute (CREE). The design and implementation of the survey was completed with the assistance of the Polish Banks Association (PBA). Hopefully, this is the first of many surveys of housing finance which will provide the PBA, and the banks, with a timely assessment of the market and the trends over time in mortgage finance, and commercial and developer credits.

5 See the comments in Michael Lea, "Global Models for Funding Housing: What Is the Best Model for Poland?" It is noted there that commercial banks in developed countries hold between 20% to 40% of their assets in mortgages; thus Poland might reasonably expect to head toward this share in the longer term.
The survey was conducted in the fall of 1999 in all banks which are members of the Housing Committee of PBA. Data for December 1999 was obtained from the National Bank of Poland, which for the first time now reports aggregate mortgage finance; the breakdown for the December 1999 data differ slightly from the survey data.

Mortgage lending (residential lending) is the sum of credits to individuals and short-term credits to builders on behalf of individuals. It may include a small volume of non-mortgage housing loans.

See Estates News Warsaw, September 1999, p.8, and Estates News Bucharest, September 1999, p. 19, for discussions of office space in Central Eastern Europe and NIS.


The assumptions are as follows: Average monthly household income is based on the distribution of per capita income for 1998 published by GUS and provided to the Ministry of Finance for analysis. The income groups are "deciles," that is ten groups with the same number of households in each group. The monthly per capita figure is multiplied by 3.64 (average household size in Poland). The DIM loan assumes a real interest rate of 8%, an expected maturity of 10 years, a monthly starting payment rate of 0.12 of the loan’s value, and an effort (payment to income) ratio of 38%. The price of a square meter is assumed to PLN 2000.


Even so, there are signs that the banks avoid risk rather than developing markets. See Business Central Europe, October 1999, p. 48.