

# How to Boost Rental Housing Construction in CEE/SEE Countries

By Wolfgang Amann

Managing Director, Institute for Real Estate, Construction and Housing Ltd.

## 1 Introduction

Economic growth in central and south eastern European countries shows promising results. The growth rate of GDP for this region for 2005 and 2006 is expected to exceed the growth rate of the EU-15 members. As GDP growth in EU-15 will be 1.9% in 2005, for CEE, 3.6% and for SEE 4.8% is expected. For 2006 the forecasts are similar with 2.2% for EU-15, 4.1% for CEE and 5% for SEE.<sup>1</sup>

These positive results have also spilled over into the housing sector. All countries report an increase in mortgage loans and new construction of dwellings. However, rental housing construction and refurbishment of multi-storey panel buildings have not yet benefited from this trend. Although considerable action has been taken by the individual governments, progress in these two areas is still sluggish.

Within this framework, the Institute for Real Estate, Construction and Housing in Vienna (IIBW) is preparing a Feasibility Study on "A Housing Finance Agency (HFA) for Central Eastern and South Eastern European Countries". This study will be developed by an international team consisting of banking practitioners, experts in housing finance and housing policy. Financing partners are Austrian and international research funds as well as international commercial banks with market interests in CEE/SEE countries. A project advisory board is headed by Dr. Erhard Busek, the Special Coordinator of

the Stability Pact for South Eastern Europe. Members are amongst others representatives from target countries, international organisations, development banks and commercial banks.

The study is based on the main hypothesis that insufficient rental housing construction is particularly due to lacking or ill-functioning financing instruments. The team examines different housing promotion schemes aimed at linking the potentials of national housing policy, international development banks to commercial banks and housing developers. The institution will be organised in form of a Public Private Partnership (PPP). It is viewed as a promising model to promote rental housing construction. Thus, the article will lay down the main objectives of this new institution and the expected benefits of its future work. It is expected that the Housing Finance Agency will be able to link promising housing developments to quality issues of the housing stock and adequate financing models in cooperation with public and international institutions and commercial banks. The feasibility study is likely to be completed in spring 2006.

## 2 Housing markets in CEE/SEE Countries

In the transition period, most CEE/SEE countries have actively encouraged homeownership by means of mass housing privatisation and the introduction of several

subsidy programmes for housing. As a result, many countries have achieved high levels of home ownership (average of 68% of total occupied dwellings in CEE and above 80% in SEE countries) in comparison with EU15 (about 62 %) and the United States (approximately 67 %).<sup>2</sup> Data on rental housing are inconsistent, which is partly due to unclear classification. Graph 1 gives an overview about housing tenancy in selected CEE/SEE countries. Social renting is classified as public rental plus cooperative housing. Older publications show lower levels of rental housing, but higher shares of "others". This of course implies quite different conclusions.

Some Central European countries have kept a considerably high level of social rental dwellings, in particular municipal housing and rental dwellings of housing cooperatives. It is around one third of the housing stock in Czech Republic and Poland and still nearly 20% in Slovakia. Almost no social renting has remained in Hungary and Slovenia as well as in all SEE countries.

Due to economic constraints during the transition period, housing construction has decreased considerably. Only construction of single family houses has by and large not been affected. However, multi storey and particularly rental housing construction has come more or less to an end. This trend changed at the end of the nineties, when multi storey housing construction gradually recovered. Today overall construction rates

<sup>1</sup> WIIW (2005), IFC (2005).

<sup>2</sup> OECD (2005), PRC (2005).

in some CEE countries already come close to the EU 15 average although there are serious deficiencies:

- Housing in CEE/SEE is characterized by underinvestment for more than 15 years. Therefore a construction rate close to EU 15 average is far below the needs. Parts of the housing stock are in a state of disrepair. Replacement of these is indispensable in the medium-term.
- The allocation of flats in stock does not reflect demand. Economic changes have strengthened the metropolitan areas and weakened rural areas. There is an oversupply of housing in disadvantaged regions and a depressing shortage on housing markets in the metropolitan areas.
- The markets particularly produce condominiums for higher income segments. Even though a surprisingly high number of households is able to afford upscale condominiums, the specific demand of middle and lower income groups is not covered at all.

- There is still almost no rental housing construction.
- The increase of construction output in some countries is strongly related to new housing subsidy schemes. A change of these models may cause serious decreases of construction output. This recently happened in Hungary

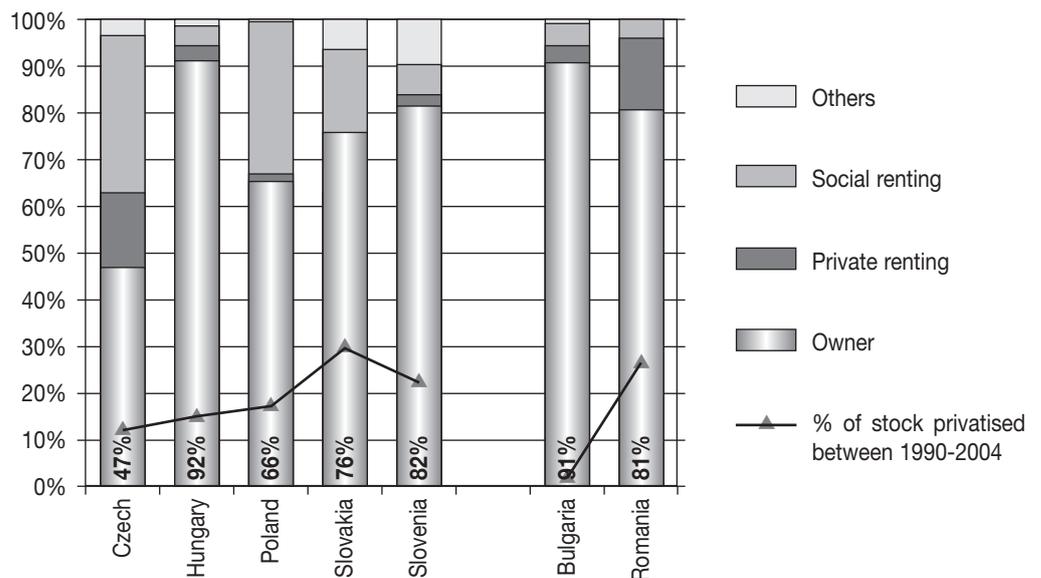
The average household size is 2.8 persons in CEE and 3.3 persons in SEE countries. The number varies only slightly in CEE from 2.6 persons in Hungary to 3 persons per household in Slovakia. Notably large households are found in Kosovo (5.6) and Albania (4.2). In other SEE countries the household size is below 3 (Bulgaria, Romania, Serbia). The useful floor space per capita is ca. 26m<sup>2</sup> in CEE countries and only 16m<sup>2</sup> in SEE countries.

The data for housing expenditure, ie the part of household incomes which has to be spent for housing, are inconsistent. Average household incomes in CEE countries are about €400 per month, in SEE countries €210 (in EU 15 it is €1,960). Following the

data of PRC (2004) households in CEE countries have to spend on average €100 per month for housing, which results in a housing expenditure rate of 25.4%, a level slightly above EU 15 average. For the future, heavy pressure on the development of housing expenditure is to be expected. Increasing land and house prices as well as developing markets for mortgage loans will result in rising monthly expenditure for owners. At the same time the remaining rental housing stock, with mostly regulated rents, is under pressure to be liberalised.

The high owner occupation rates also have an impact on economic development in other ways. It is one of the major reasons for low mobility. Boeri and Brückner<sup>3</sup> described the low domestic mobility in CEE countries, which is clearly below the EU 15 average. A major reason for this is related to housing provision. Workforce ought to follow job opportunities. But in areas with low economic dynamic the market prices for condominiums usually are low. The asset of a (privatised) apartment subsequently can only partly be transferred to capital. In the booming regions on the other hand the

Graph 1: Housing tenancy in selected countries, 2002



Source: PRC (2005) , Ecorys (2005), IIBW

<sup>3</sup> Boeri, T., Brückner, H. (2000).

markets are hot. Any revenue of disposing the previous flat does not cover the cost for a new apartment. At the same time rental markets are divided with very low rents for people with old contracts and very high rents for others. In a situation, when revenues of selling a flat are disproportionate to the costs of a new one, it becomes unattractive to move from one city to another, regardless of the different income perspectives.

Not only migrants but also young households are mostly affected by the present situation. Privatisation in the nineties resulted in adequate housing provision for the tenants with residence at that time. Today new households, in particular young people in the stage of social establishment, are in a less advantageous position. The choices they have are to buy property, regardless of the high price to income-ratio, to accept a subletted apartment, to queue up for a social rented flat or to stay with their parents.

Hence, demand for housing construction is most urgent in metropolitan areas. South Eastern Europe as a whole has a high backlog regarding floor space per capita. The total demand of new construction within the next decade is estimated to be far beyond 2.5m units in the Central European EU Member States. For Poland alone demand is estimated at 1.6m apartments.<sup>4</sup> For South Eastern Europe a comparable estimation does not exist. Regarding approximate population and housing stock a similar demand of around 2.5m. apartments is assumable. This is a total demand of more than 5m units within one decade!

### 2.1 Why does not rental housing construction lift off?

Although construction of condominiums has recovered, rental housing construction

is still below the required output to serve the needs of the population. This difference is due to the following reasons:

- The strong preference for property is not particularly stipulated in the national character of people. It is much more rooted in economic reasons. First of all property is regarded as a security against trouble of any kind, above all the future income situation. People experienced that property kept its value, when savings got lost and tenancy rights appeared to be insecure. Second, there is only little choice regarding investments. In countries with an underdeveloped banking sector people tend to convert their savings directly to bricks and mortar. Third, property is a way to pool the economic potential of several members of a family, including relatives who work abroad. Thus, investment in real estate promises a double dividend by having accommodation with low running costs and an increasing value of property.
- The sharp decline of public housing in the nineties was not reversed. Municipalities are only active in housing construction in a few countries (eg Poland). Generally the public sector tries to avoid being involved in housing construction again as it got rid of the obligations of a house owner by privatising big parts of the rental stock.
- Rental housing is not competitive today. As long as it is cheaper to finance property privately, renting an apartment is not attractive. For this reason there is no supply of rental flats and hence no market, which could develop.
- The profession of rental housing developers is not established in CEE and SEE countries. Currently, housing developers are often subsidiaries of construction companies. Their primary interest is to employ their own

construction division and to get returns on investment as soon as possible. Long term investments are neither their core business nor their interest. Rental housing developers in contrast must have a long term perspective. There are well functioning models all over Europe. Particularly successful is the Austrian model of limited profit housing associations, which combines market economy principles with aspects of a non-profit regime. An important aspect of this model is that these companies are responsible both for development and long-term management of their buildings.<sup>5</sup>

- Mortgage systems do not provide adequate financing yet. Even though mortgage financing is developing rapidly, there is still a shortage in institutional financing. Development of financing instruments is closely related to institutional development in the housing sector ie the establishment of housing developers.

As a result of different economic development and EU integration, finance markets and financing instruments are developing differently in CEE and SEE countries. As shown in Graph 2, the outstanding balance of housing loans in these countries remains well below the level of advanced European countries and the US. Despite the small size, the lending market for housing in the region has been sharply growing, with average growth of roughly 65% per annum. In the EU-15 countries, the growth rate is about 7% (in 2003).<sup>6</sup> The recent upward trend in the mortgage loan market is according to analysts from Fitch Ratings<sup>7</sup> due to the following reasons:

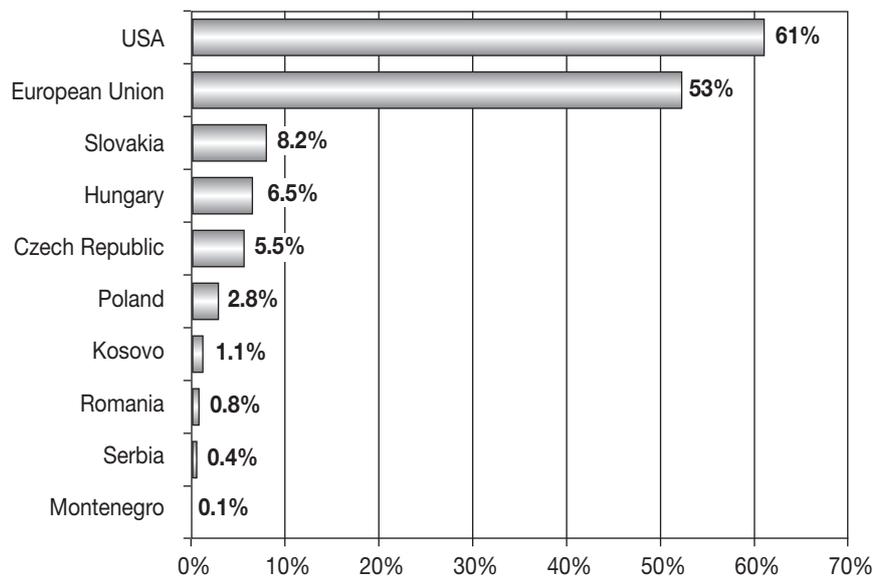
- Falling real rates as a result of EU accession;
- Growing wealth in terms of net disposable income, between 1997 and

<sup>4</sup> PRC (2004).

<sup>5</sup> Amann/Mundt (2005).

<sup>6</sup> OECD (2005).

<sup>7</sup> Birney / Steinbarth (2005).

**Graph 2: Mortgage loan to GDP-ratio in Central and Eastern Europe in comparison – as % of GDP, 2002**

Data as per 2002, SEE 2004, Romania 1998

Source: Roy (2003), PRC/Ecorys (2005)

2002 wealth increased by 30% in Hungary and by 80% in some Baltic States;

- Banking sector restructuring;
- Legal and regulatory improvements and
- Housing promotion schemes.

In some CEE/SEE countries, margins are coming close to Western European levels. Mortgage loans are often refinanced by short term deposits, exposing banks to considerable interest rate risk. All countries in CEE and some in SEE have designed adequate mortgage bond legislation. Contract saving schemes exist in some CEE/SEE countries. They mainly target single family housing construction and renovation. Their volume differs substantially from country to country.

Foreign-currency mortgages became a very important part of housing finance, in

particular in Poland and Hungary. Secondary market financing tools (eg MBS) have not yet gained importance in the region, despite intensive endeavours from the side of international institutions.<sup>8</sup>

Obstacles to further development of the mortgage loan market in SEE countries are the following:

- Low LTV ratios, which reflects that mortgages are mostly home equity loans. Mortgage loans are rarely used for home acquisition or for construction by developers;
- Additional collateral and guarantors are required on mortgage loans because of the poor legal infrastructure;
- Maturities are relatively short;
- Interest spread is still very high;
- Capital is concentrated in urban areas.

House prices are high and in some regions dramatically rising with price to income-ratios up to 17 (Montenegro, Serbia). Informal and illegal housing still is a major burden to the development of housing finance in many SEE countries. But efforts in legalisation on informal housing are achieved, in particular due to initiatives by the Stability Pact for South Eastern Europe.<sup>9</sup>

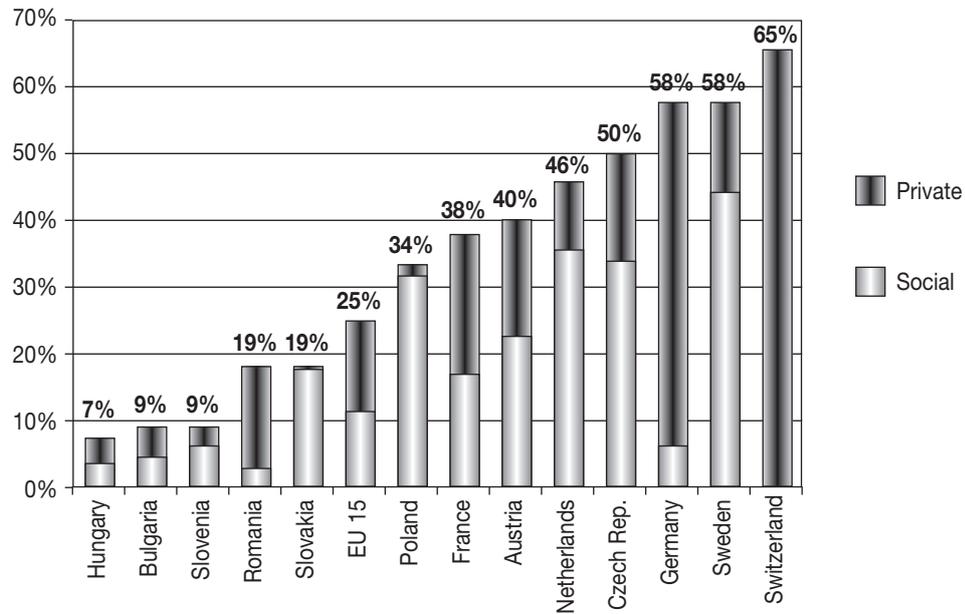
### 3 A Housing Finance Agency for CEE/SEE (HFA)

#### 3.1 Necessity to lift rental housing construction

Compared to CEE and SEE countries, in most of Western European countries a much bigger part of the housing stock is for rent (as shown in graph 3). The endeavour to reduce rental housing has cooled off meanwhile.

<sup>8</sup> UNECE (2005), p. 17 f. Birney / Steinbarth (2005). Lliev / Yuksel (2003), p. 19. Hegedüs (2002), p. 41.

<sup>9</sup> Ministerial conference on informal settlements in South Eastern Europe (2004).

**Graph 3: Rental housing stock in CEE/SEE and selected EU countries, 2002**

Note: No data for a division in private/social rent for Switzerland available

Source: PRC Bouwcentrum (2005), Czischke (2005), CH Bundesamt für Statistik

Today the following functions are attributed to social and private rental housing in western European countries:

- Social rental housing is considered an instrument against poverty and social exclusion; it is of specific importance for young households, which cannot yet afford condominiums;
- Only a housing market with supply of all forms of housing may be efficient regarding consumer choice; under conditions of efficient institutional finance it may be economically rational for the consumer to rent instead of buying an apartment; under present market conditions in many urban areas in CEE and SEE affordability of condominiums is not yet achieved;
- There are several macroeconomic advantages of a well developed rental sector: It allows for labour mobility. As

rents in social housing are usually limited, the sector is taken up as an instrument to influence total housing expenditure. In Austria, for example, the social housing sector is, due to its quantity and accessibility for the majority of consumers, able to influence even the price level of private rental market.<sup>10</sup>

- Rental housing offers institutional investment opportunities of rapidly growing importance. Due to risk spread rental housing is facing growing demand by real estate funds.

The high rate of rental housing in many Western European countries shows clearly its political significance.

### 3.2 Why a new instrument?

Despite growing awareness of the positive aspects of rental housing there seems to be

no way of a trend reversal in CEE and SEE housing construction. Rental housing is seen either outright market oriented or fully subsidized. Private rental and social rental are regarded as two strictly distinguished products. However, Western European experience shows that these two products are only a small part of a big variety of combinations. Only capital market-financed apartments for rent for the top income groups are marketable all over Europe. Fully subsidized flats, in contrast, are too costly for the state to provide more than a small group of households in need.

Higher output in rental housing is achieved in some western European countries through different tools:

- Incentives for upscale rental housing: Tax reliefs for developers, buyers or tenants are widely-used. In Switzerland, which has the highest rental rate of Europe, a specific part of capital

<sup>10</sup> Amann / Mundt (2005).

investments is to be invested into rental housing. In this way funds with favourable terms are directed to (private) rental housing.

- Complex support for rental housing for lower and middle income groups: Any country which achieved a high level of social rental housing, made use of various instruments, which combine the strengths of the state (eg as guarantor) with market instruments. The most efficient and best documented models are the Danish Mortgage Bank institution<sup>11</sup> and the Dutch Social Housing Guarantee Funds (WSW Waarborgfonds Sociale Woningbouw). High efficiency is attributed to the Austrian model of social housing finance.<sup>12</sup> The state expenditure for housing promotion is, with 1% of GDP, lower than the OECD average. Quality of housing construction and housing provision are excellent. The housing expenditure rate is, with some 18%, comparably low. Last but not least a high level of equality in housing provision is achieved. Beside state subsidies capital market instruments have proven their effectiveness, in particular the instrument of housing banks, which acquire their capital by housing construction convertible bonds. All capital is bound to go to social housing. This limitation causes intensive competition between banks for housing associations with a good credit history.

The international community assists governments in countries in transition in introducing new models of housing finance. Some, as the contract saving scheme, are working already for a long time with success, taking its contribution to single family housing finance. Strong emphasis is presently placed on the Danish model of mortgage bonds. Similar models are tried to be introduced in several countries. Others, such as some models of annuity grants, were less successful.

In several CEE and SEE countries the conditions for financing upscale rental housing, on the one hand, and fully subsidized public housing on the other hand are given. But for the big in-between no clear perspective is visible yet. This gap may be partly closed with the model of the "Housing Finance Agency", an institution which is aimed at working as an intermediary between national housing policy, international development banks, commercial banks and housing developers.

### 3.3 Social rental housing construction as a bankable product

Following the argumentation presented above, the introduction of a Housing Finance Agency as a new instrument in the housing finance markets in CEE/SEE countries is expected to achieve the following objectives:

#### **Affordable rents**

A new model only makes sense if the resulting rents for marketable flats are in a decent relation to incomes of typical households. The benchmark is a household of two earners in the civil service and a housing expenditure rate of less than 30%. Lower expenditure rates may be achieved with additional efforts by the public, eg by providing low-price land or additional customer-tied promotion (housing allowances). Resulting rents have to be considerably cheaper than privately financed condominiums. The model may be even more attractive, if a right to buy (eg after 10 years) is offered. This does not mean that rental housing for middle and lower income groups has generally to be subsidized by the public. But the public has to commit to a steering and leading role.

#### **Achievement of a substantial increase in rental housing construction**

In section 3.1, the necessity of an increase of rental housing is described as well as the

limitations of existing instruments of public housing on the one hand and privately financed housing on the other end. To fill the growing gap between these two issues, a considerable construction volume has to be achieved. A new instrument for rental housing promotion has to contribute to a medium-range upswing in rental housing construction in CEE/SEE.

#### **Conditions for introduction should be easy to fulfil**

A new instrument of low profile and high efficiency should be easily implemented in any surrounding. It should be transparent and easy to audit, as it is considered an instrument to implement national housing policy targets.

#### **Minimum subsidies**

The prerequisite for low public expenditure is a considerable involvement of market players in rental housing projects, in particular commercial banks, developers and construction companies. Affordable rents can be achieved only through low construction costs and financing costs. Subsidies have a supportive role, as much as equity and a stringent time schedule of the construction process. A major role of subsidies will lie in the substitution of equity. The need for this will diminish in the long run.

With a system of incentives and sanctions, participating market players should be encouraged to achieve results with minimal costs. Incentives and sanctions have to be pinpointed towards the involved public bodies likewise.

Efficient construction costs should be obtainable, as the intended projects, due to their size, will be of major importance for the local construction industry. Additional measures shall be taken:

- Transparent tender and awarding of construction services;

<sup>11</sup> UNECE (2005), p. 28.

<sup>12</sup> Amann / Ramaseder / Riss (2005), Amann / Mundt (2005).

- Invitation of local and supra-regional companies to the tenders;
- Fixed price offers including defined delays;
- No changes of conception behind schedule;
- Quality control and their active promotion
- Transparent and quick procedure of payment;
- Preventing interventions of the construction process by the public.

To achieve minimum public expenditure it is essential to involve commercial banks to a large extent. Rental housing construction for middle and lower income groups has to become a bankable product.

#### ***Institutional reinforcement***

The new model has to focus on the strengthening of institutional financing. The lack of an institutional framework for social housing is regarded as a major reason for insufficient rental housing provision. The setup of a third sector in housing should be promoted. This means an institution between market and state, following the principles of cost coverage, limited field of action, binding of property, limitation of profit. This type of housing developer is successfully operating in many European countries, eg in Scandinavia, the Netherlands and Austria. They ought to act in accordance with market economy principles, fulfilling policy targets of the state.

#### **3.4 Expected Results**

Within this framework the Housing Finance Agency will act as an intermediary linking the activities of the international development banks and commercial banks to the national housing policies of the target countries. The details of the organisation set-up and the applied instruments of HFA will be ready to discuss in public in the spring of 2006.

The introduction of an intermediary organisation like HFA will lead to a substantial improvement of rental housing conditions in CEE and SEE. The first steps of such an agency will be small ones. But in the course of establishing, this instrument may gain remarkable results:

- The importance of an increase in rental housing construction has been demonstrated. HFA will be an efficient tool to realize this.
- HFA represents a promising strategy to fill the gap between fully subsidized public housing and privately financed upscale rental housing.
- The model accelerates the development of institutional mortgage finance.
- The HFA will not collide with other initiatives in housing finance. HFA uses existing instruments and models by combining them in the most efficient way. In this context, western European housing finance models serve as guidelines.
- HFA may also become an efficient tool for implementing national housing policy.
- HFA will become an efficient facilitator for commercial banks to increase their financing volume with specific respect to institutional finance.
- HFA will become an efficient intermediary for international development banks to transform their products according to local needs.
- For all participants HFA will become a catalyst and a well-recognised third party for the realisation of housing development projects aimed at raising housing affordability for middle and lower income groups.

#### **Reference list**

- Amann, W. & Mundt, A. (2005): The Austrian System of Social Housing Finance (Vienna, IIBW).
- Amann, W., Lebeda, H., Oberhuber, A. & Steckel, R. (2005): Die Bürgschaft als Instrument der Wohnbaufinanzierung (Vienna, FGW).
- Amann, W., Ramaseder, S. Riss, O. (2005): Effizienz des Systems der Wohnbaubanken in Österreich (Vienna, FGW).
- Ball, M. (2005): RICS European Housing Review 2005 (London et al., Royal Institute of Chartered Surveyors).
- Birney, C., Steinbarth, M. (2005): CEE Housing Finance: Rapid Growth, but at What Risk? (Fitsch Ratings, Special Report, 7 November 2005).
- Boeri, T., Brückner, H. (2000). The Impact of Eastern Enlargement on Employment and Labour Markets in the EU Member States (Berlin/Mailand, Integration Consortium: DIW, CEPR, FIEF, IAS, IGIER).
- Buckley, R.M., Van Order, R. (2004): Housing Finance in Transition Countries: Finding Bills on the Street (Washington, World Bank).
- Council of Europe Development Bank / The World Bank (2004): Housing in South Eastern Europe. Solving a puzzle of challenges. Proceedings of the Ministerial Housing Conference, Paris, April 2003 (Paris, CEB).
- Czasny, K. (Ed.) (2004a): The Importance of Housing Systems in Safeguarding Social Cohesion in Europe. Final Report (Vienna, SRZ Stadt- & Regionalforschung GmbH).
- Czischke, D. (2005): Social Housing in the EU (Brussels, European social housing observatory)
- Donner, C. (2000): Wohnungspolitik in der Europäischen Union (Vienna, Christian Donner Selbstverlag).

- Dübel, H.-J. (2003): Housing Policy in Central European Countries in Transition (Vienna, Center of Legal Competence).
- Ecorys Hungary (2005): Housing Sector Study in Central Eastern and South Eastern Europe (Luxembourg, European Investment Bank).
- Hegedüs, J. (2002): Financing of Housing in South Eastern Europe (SEER).
- IFC (2005): World economic outlook 2002-2006 (IFC database).
- Ministerial conference on informal settlements in South Eastern Europe (2004): Vienna Declaration on Informal Settlements in South Eastern Europe (signed in Vienna on 28th September 2004).
- OECD (2002): Housing Finance in Transition Economies (Paris, OECD).
- OECD (2005): Housing Finance Markets in Transition Economies – Trends and Challenges (Paris, OECD).
- PRC Boucentrum International (2005): Sustainable Refurbishment of High-Rise Residential Buildings and Restructuring of Surrounding Areas in Europe. Report for European Housing Ministers' Conference held in Prague, 14-15 March 2005 (The Netherlands, PRC).
- Priemus, H. & Dieleman, F. (2002): Social Housing Policy in the European Union: Past, Present and Perspectives, *Urban Studies* 39 (2) pp. 191-200.
- Renaud, B. M. (1996): Housing Finance in Transition Economies. The Early Years in Eastern Europe and the Former Soviet Union (Washington, The World Bank Financial Sector Development Department).
- Roy, F. (2004): Legal requirements for models of free market management of privatised panel-block buildings in Central and Eastern Europe. In: Amann (2004): Conference proceedings "Housing Research in CEE/SEE".
- Stanton, T.H. (2005): Federal Credit Programs: Managing Risk in the Information Age (Washington, IBM Center for The Business of Government).
- Stephens, M. (2003): Globalisation and Housing Finance Systems in Advanced and Transition Economies, *Urban Studies* 40 (5-6) pp. 1011-1026.
- UNECE (Ed.) (2005): Housing Finance Systems for Countries in Transition. Principles and Examples (Genova, United Nations Publications).
- UNECE (2005): Guidelines on Social Housing (Geneva, UNECE).
- Whitehead, C. (2003): Financing Social Housing in Europe, *Housing Finance International* 17 (4) pp. 3-9.
- WIIW - The Vienna Institute for International Economic Studies (2005): Transition Countries: Back from the Peak, Growth Returns to Standard Rate of Catching-up. by Leon Podkaminer, Gábor Hunya et al. Series: Research Reports, No. 320, July 2005 (Vienna, WIIW).