

# Promoting Housing Finance Market Development in Armenia

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## Introduction

In the following we outline the comprehensive approach that Armenia is taking to develop its housing finance market. In the introduction, we provide a background on the socioeconomic and financial sector reforms implemented in Armenia during its transition to a market economy as well as a snapshot of the banking market. Further on, the article describes the situation of the Armenian housing stock and of its housing finance market. Given that background, we explain the vision that the Armenian government and the Central Bank of Armenia (CBA) developed together with KfW Entwicklungsbank to support a vibrant housing finance market. Then, the paper continues with the outline of the joint CBA/KfW development program, which assists in the creation of a strong primary housing finance market and prepares the ground for secondary market development at a later stage. Concluding, we point out early impacts of our efforts so far, offer an outlook of future challenges as well as suggestions for the involvement of other actors in strengthening the housing finance sector in the country.

Starting in 1995, the Armenian government and the CBA launched a wide program of socioeconomic reforms, starting with a massive privatization of agricultural land,

state-owned entities (at the early stages only micro, small and medium sized enterprises (MSME)) and residential property. These reforms also addressed the financial sector and in particular the banking sector. Since the Armenian government and CBA initiated these reforms, they submitted the banking sector to a significant restructuring. Programs and policies have been aimed at strengthening supervision (both on- and off-site), gradually increasing capitalization, consolidating of the banking system, integrating corporate governance and implementing anti-money laundering regulations.

The CBA continued down the reform path, broadening and deepening initial measures. In 2005, it integrated other components of the financial sector (insurance, capital market) into a unified supervision structure, and commenced to actively reform these segments. These reforms helped realize two of the essential preconditions for long-term funding and economic vitality: sound insurance and properly functioning securities markets.

The reform course resulted in macroeconomic stabilization and growth, as well as positive developments in the financial system since 2001. In the past four years, the Armenian economy has been growing at a double-digit rate, with stable inflation (under 3% pa). The forecast for the current year is similar, which has earned

Armenia the label “Caucasian Tiger” in some recent economic publications.

In the past few years, financial intermediation of the banking system has been rising gradually from a low level, with the banking sector of 21 institutions broadening its customer base under moderately increasing competition. The trend is well reflected in the figures: in 2005, total assets of the banking system and domestic loans grew by 21.2% to EUR 828 million and an impressive 34 % to EUR 555 million respectively. Notwithstanding this positive trend, the level of financial intermediation in Armenia remains unsatisfactory. The ratios of banking system assets to GDP and loans to GDP stand at 19.8% and 8.3% respectively (rising 0.6 and 1.3 percentage points). The low level of financial intermediation is confirmed by relatively high interest rate spreads in Armenia. In 2005, these ranged between 13% and 16% pa<sup>2</sup>: high in comparison to those of more advanced markets, such as the average 5% pa of the Baltic and Central European countries.

Such high interest rate spreads are partially explained by the small size of Armenian banks. However, another important factor is the limited supply of funding at adequate maturities. The demand for long-term loans is growing but “long” savings in the economy are virtually non-existent. The mismatch in attracting and allocating

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<sup>2</sup> CBA (2006)

financial resources generates a need for additional coverage against expected losses from related risks (liquidity, interest rate, etc.).

**The housing situation and housing finance market in Armenia**

With the collapse of the Soviet Union and the interruption of financing from the central Soviet budget, all major construction of residential housing stopped. In most cases, the construction of 80-90% of the finished multi-floor buildings remains incomplete. Large blocks of concrete stand unfinished and uninhabited in younger quarters of the capital city Yerevan and other major towns. This implies that most of the available housing (except for privately driven construction of expensive villas and small stand-alone houses) dates back to the period from the late-1960s until the mid-1980s.

The current condition of this inherited housing stock is dire and is deteriorating further for three main reasons:<sup>3</sup>

- Armenia is located on an unstable tectonic plateau and the most recent

large earthquake in 1988 caused major damage to housing in northern and central parts of the country, including Yerevan;

- no major repair and maintenance projects to prevent the gradual ruin of existing multi-apartment buildings have been financed and carried out since the early 1990s;
- even basic everyday maintenance has been extremely limited in the last two decades, as neither the private apartment owners nor the municipalities in charge of the buildings has had the necessary financial resources.

Although the last few years are characterized by a new and growing dynamism, the observed construction boom is mainly concentrated in Yerevan city center. The newly created, so-called “elite” apartment blocks are priced extremely high and are unaffordable even for the aspiring Armenian middle class.

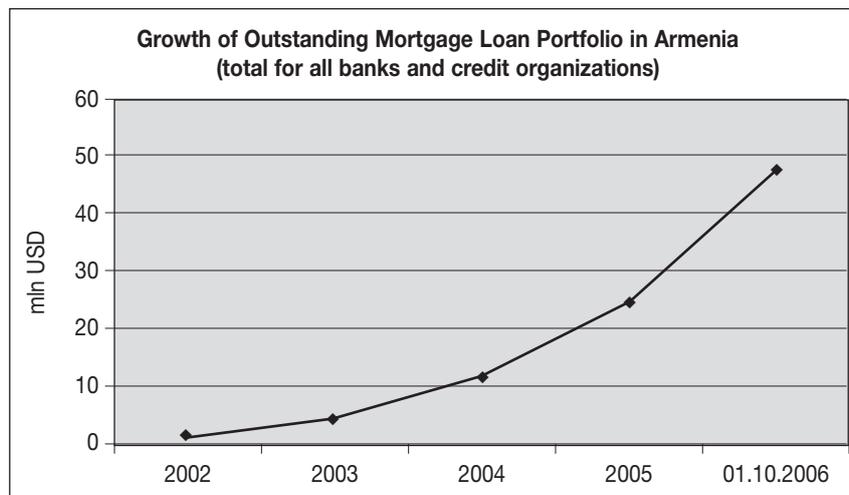
To overcome or at least reduce the shortage of affordable, good-quality housing, it is important to make housing more accessible for large parts of society. As a key

component of this objective, local financial institutions should be able to design and offer adequate financial products on a continuous basis. Through offering long-term mortgage loans with relatively moderate monthly installments, the housing finance industry will be one important part of the remedy.<sup>4</sup>

The provision of such services by Armenian banks and more recently by a few specialized credit organizations is a relatively new development in the Armenian economy, as the first housing loans were extended only in 2002. These initial housing loans were typically small loans averaging USD 5 to 10 thousand, provided mainly for incremental housing.<sup>5</sup> Beginning in 2003, financial institutions added “larger” loans, generally up to USD 30,000, for the purchase of apartments or construction of private homes to their product portfolios.

Since then, the mortgage finance market in Armenia has been growing fast, supported by favorable macroeconomic conditions and a continued strengthening of the banking sector. According to CBA statistics, the year-over-year volume of mortgage loans tripled in 2003, growing by 150% in 2004, doubling in 2005 and gaining an

**Development of Main Indicators of Armenian Housing Finance Market (Chart 1)**

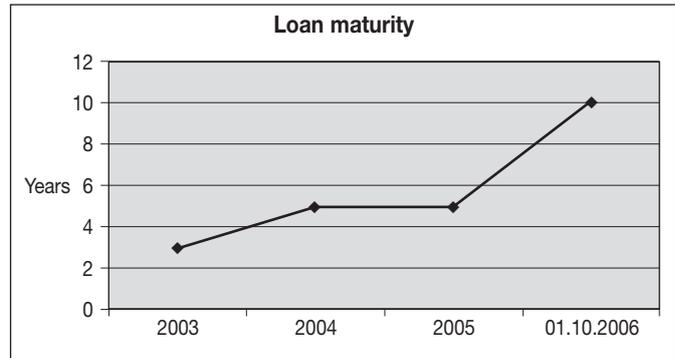
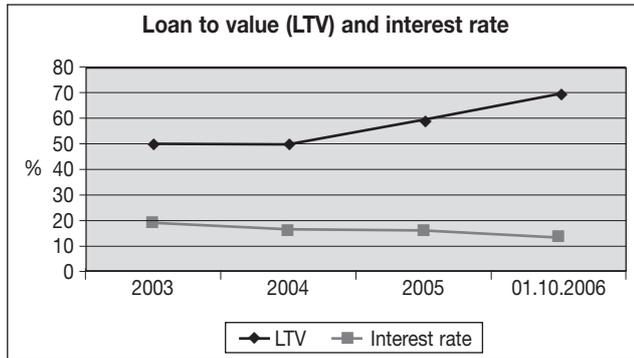


<sup>3</sup> United Nations Economic Commission for Europe (2004), p. 13-16, 18-20

<sup>4</sup> Ibid., chapter V

<sup>5</sup> Incremental improvements of housing are the refurbishment of a house or an apartment room by room, the replacement of parts of the roof or the addition of a new room.

## Development of Main Indicators of Armenian Housing Finance Market (Charts 2 and 3)



additional 90% during the first nine months of the current year, resulting in a total outstanding portfolio of around USD 50 million as of 1 October, 2006 (see Chart 1).

This growth is mainly supported by improving terms and conditions on the supply side: as of early 2003, a typical housing loan had a maximum loan-to-value (LTV) ratio of 50%, an interest rate of 17-20% pa and a maturity of three years. As of mid-2004, the typical LTV and interest rates were similar, but the most common maximum term had become five years. Currently, an interest rate of 13-16% pa is common – with some banks offering a rate of 10-12% pa to customers with long and positive financial records; and the main mortgage lenders recently extended the maximum maturity to 7-10 years (see below Chart 2 and 3).

Even though the total mortgage loan portfolio of Armenian banks has been growing quickly, the supply of such loans is still limited to comparatively higher income groups of society. Therefore, the Government of Armenia and the CBA, supported by KfW Entwicklungsbank, have conceptualized a program, which shall have

a two-tier impact: first setting conducive “rules of the game”; and second, increasing the supply of long-term funds for mortgage lending in the local financial sector. This approach will improve the supply of housing credit, decreasing the mismatch of the “demand-supply” relation. Most importantly, it will facilitate access to these loans for mid- to lower-income social groups, making housing credit “more affordable” for the general public.

#### Developing a Strategic Vision for the Housing Finance Market

Given the limited financial capacity of the Government of Armenia to cater to the growing housing needs of the Armenian population, the authorities have shown great interest in stimulating private sources of funding to serve these needs. This would allow concentrating the Government’s scarce resources on the neediest part of the population. The main conduit for the mobilization of private resources would be the financial industry, offering long-term mortgage loans. However, many enabling factors for the development of a vibrant housing finance market have been missing.

The CBA, together with the Ministry of Finance and Economy, took the lead in improving the situation. Both developed their visions of a strong housing finance market, emphasizing the need to first strengthen the legislative and regulatory framework, and thereafter the institutions of the financial sector. The goal set by the Armenian authorities was to support the quick development of both lending institutions (commercial banks and credit organizations<sup>6</sup>) and insurance companies to accommodate market development; to develop adequate mortgage and housing saving products; and to create a sound primary market, upon which a secondary market would be based.<sup>7</sup>

With these concepts the Armenian authorities turned to KfW Entwicklungsbank, a long-term partner in developing and strengthening the financial sector under the umbrella of bilateral German-Armenian Financial Cooperation (FC).<sup>8</sup> Together the partners commissioned a pre-feasibility and feasibility study to structure the overall approach to market development and KfW Entwicklungsbank’s contribution. From the beginning, the assistance was designed to take a systemic

<sup>6</sup> Non-bank financial institutions are not entitled to accept deposits.

<sup>7</sup> Central Bank of the Republic of Armenia (2004) and Ministry of Finance and Economy of the Republic of Armenia (2004)

<sup>8</sup> KfW Entwicklungsbank conducts German FC on behalf of the German Federal Ministry for Economic Cooperation and Development. In financial sector development, the CBA and KfW Entwicklungsbank have so far successfully cooperated in introducing a viable deposit guarantee system, as well as a revolving refinancing scheme for MSMEs through local commercial banks (“downscaling”) under the framework of the German-Armenian Fund. The Ministry of Finance and Economy and KfW Entwicklungsbank have set up the Credit Guarantee Fund, which provides partial ‘AAA’ guarantees to facilitate borrowing of Armenian commercial banks on the international capital markets. These guaranteed loans are used to finance medium-term loans for local small and medium enterprises.

approach, encompassing legal and regulatory advice, the establishment of minimum quality standards (MQS) for the market<sup>9</sup> and for products, provision of long-term financing to the development of a secondary market in the country as well as assistance in the coordination of all donor activities in this sector. The Government of Armenia entrusted KfW Entwicklungsbank with this wide “mandate” based on the successful prior cooperation.

During the preparation and design phase of the program, German FC financed consulting services to assist the Government of Armenia in creating a strong legal framework for housing finance in the country. The foundation of a strong legal framework provides a favorable environment for borrowers, financial institutions and other market participants. Although “the legal framework for the primary mortgage market [had already been] reasonably strong, particularly as compared to other transition countries in the region,”<sup>10</sup> the Armenian Government had decided that additional improvements to the legal and regulatory environment of the primary housing finance market would further enhance the growth potential of mortgage lending. The review and recommendations of the consultant on the current legal framework and new legislation under consideration were incorporated into the legislative process in two stages.<sup>11</sup> Thus, the Government of Armenia had already set conducive framework conditions for housing finance at the inception of the market.

As the legal and regulatory framework is but one of the success factors of a sound market environment, German FC also supported the Armenian market participants in the creation of adequate rules and unified practices in the form of MQS for mortgage lending. These voluntary standards will facilitate the creation of quality mortgage

products, contribute to consumer protection, and improve originating, servicing and risk management. They will also help create a secondary market by attracting potential investors, which in turn will contribute to an increase in sustainable long-term sources for mortgage lending. The sound legal and regulatory framework and the MQS will allow borrowers to benefit from lower monthly installments, bringing better housing into the reach of lower-income households.

Upon these foundations, market participants will be able to build their mortgage portfolios. However, this will not be possible without a further prerequisite for affordable long-term housing finance products: the availability of refinancing with similar maturities – either from local capital markets, international financial investors, donors or international development finance institutions. The first option would be most desirable. It is the goal of the Government of Armenia and the CBA, as it would make funding available in local currency and would be less vulnerable to external shocks. However, a capital market that is both long-term and liquid does not yet exist in Armenia. At the same time, international financial investors are not yet prepared to invest long-term funds at a sufficient level in the country. Until the establishment of a viable local capital market or increased risk appetite by international financial investors, donors and development finance institutions, such as IFC, EBRD or KfW Entwicklungsbank, are the main sources of long-term funding for local financial institutions that matches their mortgage portfolios.

As the objective is to create a secondary market at a later stage, the feasibility study recommended structuring the refinancing facility under the German FC program as a liquidity facility, which refinances newly funded housing loans in local currency that

meet certain conditions. In fact, the CBA and KfW Entwicklungsbank had already been running a similar local currency refinancing program for MSME lending, which will be used as a platform to develop an adequate housing finance program. Moreover, this set-up will facilitate the introduction of future secondary market operations.

Finally, making housing finance accessible to the previously unbanked and mainly lower-income groups is an important objective of the Government of Armenia. Although households may have sufficient income to repay a housing loan, this remains difficult for them to prove in many cases. As many Armenians do not yet use formal financial services and positive credit information from other sources is not available, banks and credit organizations have difficulties in determining new clients’ creditworthiness. In addition, the high level of income from informal sources and remittances of large segments in the Armenian population makes it very difficult for financial institutions to establish the payment capabilities of private persons to service a loan, be it short- or long-term.

Therefore, the feasibility study advocated the introduction of a ‘contractual saving scheme for housing’ (CSSH). A CSSH would allow customers to establish their creditworthiness with a lender by saving a regular amount for an agreed period.<sup>12</sup> As a result, the lender would be able to grant a housing loan, knowing that this customer has reliably paid in money over an extended period of time. On the other hand, the customer would benefit from a longer repayment term, thus lowering the actual redemption rate and raising overall affordability.<sup>13</sup>

Based on the recommendations of the feasibility study, the Government of Armenia and the CBA, together with KfW

<sup>9</sup> MQS include standards in underwriting, documentation, administration and data collection. They are aimed at establishing effective and efficient mortgage lending procedures and improving the risk management of mortgage loan portfolios.

<sup>10</sup> Rabenhorst and Butler (2005), p. 4

<sup>11</sup> For recommendations of the reports see Rabenhorst (2004) and Rabenhorst and Butler (2005).

<sup>12</sup> The proposal for an Armenian CSSH does not foresee a subsidy (“savings bonus”) to be part of such a product.

<sup>13</sup> Rabenhorst et al. (2005), p. 41-43.

Entwicklungsbank, developed their program to support housing finance market development.

### Implementing the Vision

Toward the end of 2005, and coinciding with market expansion, market participants became more active and initiated an organization of the core players in the housing finance market. These included banks and credit organizations on one hand and insurers and real estate agents on the other. By March 2006, twelve organizations founded the Mortgage Market Participants' Association of Armenia (MMPAA). The MMPAA's main objectives are the development and continuous improvement of the MQS and representing members' joint interests in regard to the legal and regulatory environment in their dealings with the CBA and other authorities. The still very young MMPAA has already proved itself capable of maintaining dialogue regarding MQS with the main policymakers and is successfully cooperating with foreign experts in charge of market development as well the institution, which provides staff training courses to the sector.

As a result of the feasibility study, the Armenian and German governments agreed to promote market development by focusing on a strong primary market before continuing with building a secondary market. German FC provides an initial FC Loan<sup>14</sup> of EUR 6 million for long-term refinancing of mortgage loans as a new program under the German-Armenian Fund (GAF),<sup>15</sup> which manages a kind of liquidity facility. An additional FC Loan of EUR 6 million for the same purpose is under consideration for the 2007 German-Armenian intergovernmental negotiations. This second tranche can be further increased by blending it with capital market

funding to broaden the socioeconomic impact of the program. In addition, an agreement for an FC Grant of EUR 1.5 million has been signed for accompanying measures to the program, ie consulting services supporting the investment, strengthening the financial sector and assisting the coordination of donor activities.

In a local tender – a two-tier process with quantitative and qualitative parameters – the GAF has approved eight partner financial institutions (PFIs) out of 18 applicants – six banks and two credit organizations specialized in mortgage lending. Under the program, the GAF will provide the PFIs refinancing lines with maturities of up to eight years for their mortgage portfolios in local currency. The refinancing rate to the PFIs will be set based on the market environment and the anticipated demand by the PFIs. This will support two important policy goals set by the CBA: extending the maturities of (housing) credit and reducing the degree of dollarization in the economy.

To be eligible for refinancing, loans presented must adhere to the MQS, have a minimum maturity of ten years and an amount of less than AMD 12 million.<sup>16</sup> The refinancing window will operate from February 2007, allowing all PFIs to establish necessary internal structures and processes in advance and to have an adequate number of qualified staff available. As the refinancing will be provided on a continuous, revolving basis, with net revenues being retained for additional refinance, the GAF shall be able to sustainably support the development of the housing finance market in the long run.<sup>17</sup>

The consulting services under the program began in June 2006 to prepare the GAF refinancing window. The program

consultant, Bankakademie International, started its assignment by the creation of a housing finance training program (HFTC) in cooperation with a local training institute. Based on the MQS, the training courses offered will provide necessary qualifications to loan and risk officers as well as managers of banks and credit organizations. The classes are open to other market participants (eg, insurance companies, appraisers, realtors) as well, in order to create a coherent understanding of the market's standards with a broad range of actors.

The purpose of the HFTC is to establish high quality standards in lending institutions to further strengthen the Armenian financial system as a whole and to improve overall service quality for borrowers. By now, only five months after kick-off, the curricula are established, local trainers have been selected and educated, and the first round of courses both for loan officers and managers has already taken place. The local training institution will offer the HFTC regularly to ensure an adequate supply of qualified professionals that will be required to sustain the rapid expansion of the housing finance market.

The work on the CSSH with the CBA and interested commercial banks will commence in 2007. The general design will likely include a long-term savings component at market rates in regular installments. The loan component may offer a lower interest rate on the loan, a higher loan amount than the savings amount (eg a multiplier of 2) or any combination of the two options. However, the bank will reserve the right to decline a loan offer in case the customer is not creditworthy. In this case, the bank will pay back the savings (including interest) to the customer. CSSH could be denominated either in USD or AMD.

<sup>14</sup> FC Loans are granted at the internationally agreed terms and conditions of 40 years maturity, 10 years grace period and an interest rate of 0.75% pa.

<sup>15</sup> The GAF is a revolving refinancing fund established back in 1998 under the umbrella of the CBA. Up to now, it has been providing local currency credit lines to five local banks for lending to MSMEs.

<sup>16</sup> AMD 12 million equal about EUR 24,700.

<sup>17</sup> The program would be able to refinance an outstanding portfolio of a minimum of at least 800 housing finance loans (estimated average loan size: EUR 15,000) at the same time. Given the option to leverage of the FC loans through capital market funds, the revolving nature of the refinancing window and the increase through interest earnings, the overall impact of the program's refinancing will be much higher.

In the framework of the program, the Government of Armenia has requested that KfW Entwicklungsbank take the lead within the international donor community in the housing finance sector. The purpose is to catalyze the cooperation between various projects in this field and to facilitate the coordination among the donor organizations and development finance institutions, which provide funding, technical, and institutional assistance to this segment of the Armenian financial sector. In addition to KfW Entwicklungsbank, the main international bilateral and multilateral organizations that have declared their strategic interest in developing the mortgage lending market and supporting the enabling legal-regulatory environment include USAID, EBRD, IFC, ADB and the World Bank.<sup>18</sup> For the sake of avoiding duplication and overlap of activities among different programs, thus maximizing the efficiency of the use of scarce financial resources available to this sector, KfW Entwicklungsbank has assigned a Local Coordinator for Housing Finance (LCHF) to the Government of Armenia and the CBA. The LCHF has commenced his assignment parallel to the program consultant team in July 2006.

In preparation for strong growth of the long-term mortgage finance market and accompanying demand for long-term refinancing, the Government of Armenia and the CBA also receive legal advice for the creation of adequate secondary market legislation, within the scope of above consulting services. Given that the direction of market development cannot be foreseen at this early stage of its development, it seems likely that the draft laws both on covered mortgage bonds as well as securitization and asset backed securities will be developed. Currently, the Government of Armenia and the CBA are elaborating these draft laws in cooperation with the consulting team. An early adoption of the laws would allow the market participants to prepare well for the first

deals in the secondary housing finance market in a few years time.

### Summary and Outlook

Despite being early in the process, the program's launch already seems to have contributed to increased competition and improved quality of mortgage products and services in the market. Armenian financial institutions have started to increase the longest maturity on offer to ten years, interest margins are tending downwards and the MQS have already been applied by several lenders. This indicates that the program is set to achieve its two-pronged overall objective (improvement of the housing situation of lower income households with a parallel development of the financial sector) over its life and beyond. Based on improving market conditions, the establishment of the housing finance refinancing facility under the GAF toward the end of this year, and the anticipated availability of other sources of long-term funding, growth in the volume of outstanding housing loans to approximately USD 100 million by the end of 2008 is highly feasible. In fact, as long as there is no economic downturn or political crisis, the housing finance market can be expected to be a major growth factor for the Armenian financial sector overall. The potential for growth becomes evident when comparing the ratio of mortgages to GDP of less than 1% in Armenia with the figures in the most developed markets such the EU and the USA with 45% and 78% respectively.<sup>19</sup>

However, the effort to sustainably develop the housing finance market encompasses and requires more than what is being done in the framework of the program supported by KfW Entwicklungsbank. First of all, the program's volume of long-term refinancing is too low to support the anticipated growth of the primary market alone. It would be highly desirable if other development finance institutions and investors

contributed significant amounts of their own. Moreover, many other areas, closely linked to housing finance, need to be developed in parallel: pension funds, insurance, consumer education and real estate appraisal just to name a few.

In addition, construction/developer finance as well as housing microfinance finance should be introduced in the Armenian market. The former is an important instrument to allow the supply of housing to grow at a similar rate as the demand for new housing, which will be fueled by the increased availability of housing finance. Without developer finance, the supply of new units may be outpaced by demand, resulting in price inflation instead of improved housing availability for Armenian households.

In addition to CSSH, housing microfinance is an additional tool to assist lower-income groups with loans to incrementally improve their housing situation. As the credit technology required is very similar to micro lending for businesses, the development of housing microfinance products can build on the successful introduction of micro lending within the framework of the GAF. It will also benefit from the legal, regulatory and quality improvements made in connection with mortgage lending in general.

As we have illustrated, the Armenian housing finance market is growing rapidly in a fertile and sound environment. Even though the prospects are bright, much work still needs to be done to allow this market to reach full bloom and to improve the housing situation for low- and middle-income households. As there are many chances as well as challenges, we invite Armenian as well as international actors to seize the market opportunities and to develop solutions for continuous growth together.

<sup>18</sup> USAID plans to provide technical assistance for reforming the regulatory environment and staff training, without attaching funding to its program. In contrast, IFC and EBRD will inject additional funds into the market, by extending direct lines of credit to local financial institutions, whereas ADB and KfW do not work directly with private sector entities but have to coordinate their activities with the government.

<sup>19</sup> Porteous (2006)

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