Poland : Building a New System of Housing Finance

by Margret Thalwitz

OVERVIEW

Housing used to play an important role in Poland's economy through out the 1980's: it accounted for approximately 6 percent of GDP and 18 percent of total investment; construction jobs hovered around 7 percent of total employment while between 8 and 13 percent of the central government's expenditures were devoted to housing subsidies.

Until the adoption of the Economic Transformation Program (ETP) of January 1990, housing used to be considered as a social good which the State should provide to all citizens at only a notional cost. In fact, most households received an administratively assigned dwelling for which they paid only 3 to 6 percent of monthly incomes. As long as the consumption of housing bore no relation to income, nor to production costs, demand outstripped the delivery capacity of the state-controlled supply system. Housing became an issue of national policy because of enduring shortages, exorbitant grey market prices, waiting lists of 10 to 15 years, low turnover rate and misallocation of living space.

HOUSING STOCK

Poland's Housing Stock is currently estimated at nearly 11 million dwellings, about 10 percent short of the number of households.[1] Four basic types of investors have operated during the past 40 years: the state or communes, the enterprises, the cooperatives, and the private sector. 46 percent of all units are privately owned, and most of those (2/3) are located in rural areas. In the cities, about forty percent of the housing stock consists of communal rental units, which are subject to strict rent control.[2]

MARGRET THALWITZ is Senior Economist in the Central Europe Department of the World Bank. She has been extensively involved in the World Bank housing projects in the former socialist countries.

Public Housing

More than a fourth of urban housing is owned by the State and managed by the Municipalities or *gminas*. Half of these units consist of nationalized property which dates back to the pre-war era. Another 39 percent were built by public authorities between 1945 and 1970, while only 11 percent have been produced in the past twenty years. To a large extent the "age" of public housing reflects its physical conditions and relative endowment with modern amenities such as a separate bathroom or central heating. In general, the quality of public housing is poorly correlated to the income of its occupants because considerations of relative economic welfare did not influence housing allocation until 1965 and the criteria for eligibility were often circumvented even after. Rents are still set administratively by central authorities according to a national rate per m² of usable space which, despite periodic adjustments, consistently falls short of the expenditures incurred in the operation and maintenance of the stock (subsidies are estimated to cover 65 percent of such expenditures). Attempts at divestiture of public housing were initiated as early as 1970, when units were offered for sale to sitting tenants at prices well below current market prices (often as low as one-twentieth). After some response during the first two years, purchases declined rapidly only to pick up again towards the middle of the 1980's when inflation accelerated. According to official estimates, no more than 15 to 20 percent of the public housing stock (possibly the most attractive portion) was privatized during the last two decades.

Enterprise Housing

This category of dwellings, built and administered by the state enterprises for their own employees accounts for about 13 percent of the existing housing stock. In the old system, the provision of housing in proximity of the workplace was considered an obligation of the enterprises: a fringe benefit awarded to the worker to complement generally low wages. Enterprise flats are subject to the same rent control regulations at communal flats, leaving the enterprises with a heavy burden of operation and maintenance costs. This approach diverts resources from one sector of investment to another and tends to tie labor to a given job and residence over a lifetime. The occupants usually remain in the units after their employment contract has expired, and their rights of tenancy are strongly protected.[3] As many of the enterprises are now expected to be privatized, their housing assets would become a natural target of divestiture. A significant portion of enterprise housing (43 percent) was built over the past two decades and is therefore of generally better quality compared to communal housing. The purchase option (made available in 1970 also for this type of accommodation), was taken up less frequently than in the case of public housing even though the buyers could get freehold property title and could rent or sell the units at market prices.

Cooperative Housing

Cooperative housing accounts for 37 percent of all dwellings in the cities, where large estates of multi-story apartment blocks have been provided by this kind of investors during the past. Occupants of cooperative flats can be either "tenants" or "owners", depending on the type of contract and down payment they enter into,[4] cooperative dwellings have benefited from large subsidies through grants and preferential interest rates. Unlike the holders of state flats, who pay minimal rents only, cooperative members have traditionally been charged for a small portion of the capital costs and a fee to cover the operation and maintenance costs of buildings. While still very low compared to housing cost in a market economy, the monthly charges on cooperative housing used to be somewhat higher than those of public housing occupants.

Private Housing

Most of the private stock (64 %) is found in rural or semi-rural setting and is made of farm-houses. Although less endowed with modern amenities, rural housing tends to be roomier in size (the average living space is of 70 m² against 54 m² for urban dwellings). Private housing in cities consists basically of multistory apartments, townhouses and relatively few single-family detached. No privately owned housing built after the war is subject to rent-control or other restrictions to sale or to rent at market prices.

THE STATE OF HOUSING FINANCE

The Subsidy Issue

Subsidies in support of housing are large. Part of these subsidies are on the budget and can be easily identified. They have accounted for some 2 to 3 percent of GDP and between 8 and 13 percent of total budget expenditures during the 1980s. In addition, housing also bears substantial subsidies that go unmeasured, the most important being the difference between the rent actually paid by the household and the rent it would be charged if the price mechanism were to clear the housing market. These subsidies are regressive and mainly benefit urban dwellers of cooperative enterprise and public housing irrespective of family income and size. Rural dwellers enjoy very little housing subsidy if any.

Past Housing Finance

Until 1988 housing finance was simple. The National Bank of Poland (NBP) provided investors with 43-year loans at 2 percent interest, financing those loans with transfers from the state budget. After a three year grace period in which the interest during construction was capitalized, loans were converted to a repayment basis over 40 years. With the exception of a small portfolio of loans issued to individuals (less than 4 percent of the total), housing finance consisted mostly of loans made to approximately 4,000 housing cooperatives. These tended to be large, with the 500 largest loans accounting for 85 percent of total credit.

In 1989, the NBP transferred all cooperative housing loans to PRO BP, the National Savings Bank, along with the inflation-stricken passbooks of 2.5 million enlisted members of housing cooperatives. PKO was soon overwhelmed by the new burdens. Problems arose with rapidly escalating construction costs, acute general inflation and the sharp increase of interest rates, which became adjustable in January 1990. These events had an immediate effect on the housing portfolio and forced the Government to intervene because of the ensuing crisis of affordability. In addition, most construction loans had to be renegotiated for over increasing amounts because building costs were rising even faster than inflation.

Current Forms of Subsidy

Subsidies to the sector have taken three distinct forms:

- below-market rents for tenants of rent controlled housing;
- low charges for utilities, especially for centrally supplied heat and hot water; and
- grants for cooperative flats that replaced interest rate subsidies.

Utility charges are rising steadily and payments now account for about 15 to 18 percent of average household income, severely limiting the Government's ability to increase rents without imposing affordability constraints on a large number of households. On the housing finance side, subtle changes have been introduced since 1990 initially all geared to reducing the budgetary burden of large and exponentially growing interest rate subsidies. Below market rates of interest were abolished as of January 1, 1990, and all housing loans have since been charged positive real rates. These rates, however, have made loan payments unaffordable for virtually all borrowers in the country prompting the Government to introduce interest capitalization by the lending bank, PKO BP, while purchasing quarterly a large portion of the capitalized interest with government debt. While PKO's cash flow has not been impaired, the Government has rapidly acquired a large portion of the bank's housing portfolio. Its share is likely to reach about 50 percent by the end of 1994. Although the Government's portion of the loan carries, in principle, the same terms and conditions as PKO's portion, there is a widespread feeling that the Government will eventually forgive repayments. At present values, this subsidy would be in the order of 2.5 percent of GDP.

THE GOP HOUSING STRATEGY AND WORLD BANK SUPPORT

The Approach

Realizing that the wrong housing sector policies can pose a serious threat to fiscal and financial stability, the Government has started to lay the foundation of a sustainable, non-subsidized housing finance system. In September/October 1991, it has changed the cooperative law to allow mortgages to be issued to individual members rather than to the cooperative at large. It has also adopted the principle of indexing and repayment adjustments for all housing loans. These decisions imply that a clear distinction will be made in the future between construction and mortgage loans and that the borrower of a construction loan (e.g. a cooperative) can be distinct from the borrower of the mortgage loan (i.e. the buyer of the house or unit). More importantly, banks will now be required to include in the assessment of their credit risk the borrowers' ability to pay, a principle not hitherto applied to cooperative housing loans. The mortgage instrument adopted by the Government would requires a source of long term capital.

Most of the loans held by the National Savings Bank (PKO BP) are unlikely to be fully repaid. To address the fiscal and financial problems arising from this large portfolio of old housing loans, the Government might also consider discontinuing the practice of capitalizing interest on PKO's outstanding housing loans which are not likely to be repaid. Instead, Treasury bills could be issued for the amount of provisioned loans.

Implementation of the Government's housing strategy requires the routing of several innovations in the legal system. The main issues are the equal protection of ownership rights, the definition of public purpose as a basis of expropriation the management of privately owned multifamily buildings and clear foreclosure rules to support a viable system of construction and mortgage finance.

The Challenge

The longer term implications of the existing housing loans could become a major fiscal issue in the future. While the Government has attempted to tackle this issue in early 1992 by canceling construction loans that had not yet turned into long term housing or quasi mortgage loans, this decision was reversed in 1993 and repayment conditions subsequently softened. Thus, the immediate challenge faced by the Government today is not qualitatively different from that confronted in 1990: to find a non-inflationary way to restructure the existing housing loan portfolio while developing an alternative housing finance system based on market principles. The crucial first step will be to adopt sound underwriting and servicing standards and to deal with the inflation and affordability issues through the choice of lending instruments. In a financial system that is still infant, it is important to do so without inducing interest rate distortions, while at the same time providing the housing sector with sufficient liquidity to resume a minimum level of production. The longer term objective is to introduce and enforce a legal and regulatory framework that effectively recognizes mortgages as sound collateral for real estate loans.

Lack of Government action, however, to resolve the old housing loan portfolio issue is likely to hamper progress toward market-based housing finance. While the principles of dual adjustable mortgage loans (i.e. variable rate loans whose repayments are tied to a clearly specified index such as the average wage index in Poland) have been accepted by policy-makers and are being introduced through the Housing Project supported by loans from the World Bank, USAID and EBRD, there is an inherent risk that demand for such schemes will be adversely affected by the competing schemes with explicit or anticipated subsidies. One of the important lessons of the Polish experience today has been that for long-term housing finance to succeed in a difficult and volatile macro-economic environment, the principles of financial discipline should be universally enforced and competition on both the asset and liability side of the banks be enhanced. The privileges enjoyed by the State Savings Banks in most economies in transition will most likely discriminate against the development of mortgage finance unless the Governments are ready to curtail borrowers' expectations and enforce strict financial principles on the principal lender.

SUMMARY

Sequencing Reforms

The adoption of an aggressive policy of rent de-control would call for simultaneous real wage increases, which may be inappropriate in the current circumstances of the economy. On the other hand, high social risks are involved in sharply increasing rents in an environment of declining real wages, because a large proportion of the population may be unable to meet the required payments. In the absence of functioning rental market, it will be difficult to put in place a housing allowance system to complement the contributions that poor households can afford to make. Therefore, the Polish Government emphasis on developing a market for future homeowners suggests that the introduction of housing finance will take precedence over the more gradual changes in rental policies.

Removing Sectoral Constraints for Housing Finance

There is a need to increase the affordability of long-term housing finance and to encourage investment in rental housing and home ownership. There is also a need to make people realize that the consumption of housing services is not unlike that of other private goods: it is exclusive and rival, and should be charged directly to the consumers so that the quality and quantity of housing services they purchase would be determined by the level of payments they are willing to make. Important steps in this direction have been the decisions to charge the real cost of money on housing loans and to increase the share of household income devoted to the payment of rents or mortgages (March 1991).

The Government Role in Strategy Implementation

The Government has carved out its own role during the transition period in the following areas:

- continuously monitoring the housing markets;
- revising property rights, physical planning laws and building regulations;
- encouraging competitive participation of a variety of housing suppliers;
- privatizing and restructuring construction kombinats and facilitating entry of new private firms into the sector;
- servicing land for housing development;
- promoting housing allowance schemes for low income households; and
- developing an efficient housing finance system, based on sound banking regulations and well separated from targeted budget subsidies.

World Bank Assistance

The Bank's housing assistance strategy in Poland has focused on creating the basic conditions to develop private construction enterprises, to attract private resources into housing investments and to strengthen the mechanisms of financial intermediation. Bank staff has collaborated with the GOP in working out the elements of housing finance reforms. It is recognized that such strategy is just beginning to take shape and that its implementation will require a long period of sustained Bank assistance in form of policy advice and subsequent lending operations. First Housing Project that provides private investors with resources for construction and mortgage loans, while addressing those institutional and regulatory problems which still hamper their participation. Moreover, the Project would reduce the sector's demand on scarce public funds by fostering the growth of a stable source of long term finance. However, more needs to be done to fully reform the housing sector: public housing subsidies need to decline, privatization of communal housing be implemented, and remaining subsidies be better targeted to needy households. Dialogue on those issues will be pursued during project implementation with central and local authorities in the form of technical assistance and special studies. ■

NOTES

[1] In 1988 there were 1.12 households per occupied dwelling unit in Poland, as compared to 1.10 in Czechoslovakia, 0.97 in Hungary and Bulgaria, 0.93 in Romania and 0.91 in Yugoslavia.

[2] Poland's population is about 60 percent urbanized. The country has a rather balanced urban structure with five cities above 500,000 inhabitants (Warsaw, Lodz, Krakow, Wroclaw and Poznan), and many medium sized cities. Administratively, Poland is divided in 2,500 municipalities (gminas) and 9 provinces (voivodships).

[3] Until very recently, a sitting tenant could not be evicted legally unless suitable alternative accommodation was provided. Now an eviction law has been introduced but there is no experience yet of its enhancement.

[4] A surge of loan prepayments took place in 1989 when many cooperative tenants chose to become owners, paying off the outstanding balance of their housing loans to avoid high interest payments. This resulted in a chequered pattern of tenure within the same building block with tenants and owners often bickering over their respective obligations. However, most cooperative housing units are now of the "ownership" type (possibly 85 percent of total).