Moving Toward a Market-Oriented Housing Finance System in Slovakia[1]

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INTRODUCTION[3]

Achieving housing market reforms is a high priority among the countries making the transition from a planned to a market - oriented economy. Policies to strengthen and develop financial markets and financial institutions to finance housing in these countries are related priorities. Much has been written about the first topic,[4] much less has been written about housing finance.[5]

The purpose of this paper is to provide input into the emerging discussion about housing finance in transitional countries. It draws upon an ongoing USAID sponsored project to assist the government of Slovakia to develop a blueprint for housing finance reform. Four topics are addressed:

- The goals of a housing finance system and its participants are discussed in the first section;
- The conditions needed to *begin* a major housing finance reform effort and the conditions that underlie a successful market oriented housing finance system are the topic of the second Section;
- The context in which Slovakia begins its efforts to build a housing finance system is the topic of the next Section;
- Steps the government of Slovakia may consider as it begins the development of a market-oriented housing finance system are the subject of the final Section.

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Because Slovakia seems to face many of the same problems in this regard as many other transition economies, the discussion has relevance in other transition economies as well.

Many of the answers and themes offered in this paper are widely held among housing finance specialists and have been described in other forums. In this sense, the paper serves as a mini-primer on market-oriented housing finance. Some are less obvious and their significance is still being measured and debated. One such theme is emphasized in this paper: the role and potential impact of agency problems in the development of a market-oriented housing finance system.

In this context, agency problems refer to the costs that arise when a principal relies upon an agent to execute its wishes and plans. The principal and the agent do not necessarily share the same goals and incentives; as a consequence, the principal incurs costs to either monitor the performance of the agent or cope with outcomes different than those desired by the principal.

The agency problem was described recently in simpler and more direct terms by the Prime Minister of the Czech Republic, Vaclav Klaus. He says, "The government of a transforming country is the worst imaginable agent to take care of restructuring".[6] He is referring to the fact that a successful plan will end the jobs of the bureaucrats. As such, the incentive to develop such a plan for the agents (bureaucrats) is quite different than the incentive to restructure the economy for the principal (the citizens). A successful restructuring effort will probably offer incentives, e.g. cash bonuses, to the bureaucrats responsible for the restructuring effort.

We argue that potential agency problems abound in a market-oriented housing finance system. They affect the timing of the reform process and the ultimate shape of a housing finance system. As a result, efforts to develop a market-oriented housing finance system should be keenly aware of them.

GOALS OF A HOUSING FINANCE SYSTEM

The primary goal of a housing finance system is to mobilize funds to facilitate economically viable or profitable investments in the housing market. Often the borrower seeks to invest in an owner-occupied housing opportunity, though the opportunity to

become a landlord is also quite common. The lender seeks to invest in a security (a mortgage) that offers a risk-adjusted rate of return comparable to the returns available on alternative investments. A successful housing finance system may serve other purposes, but this is the most important.[7]

Housing finance is *not* intended to be a way of providing households with access to housing with income insufficient to repay the loan. It is not a system of subsidies, although it can represent a partial substitute for the subsidies provided by government to the housing sector during the previous planning regime. The fundamental difference is that funds for housing finance in a market-oriented system are generated by profitable investment opportunities whereas resource allocation decisions in the prior regime were based upon other criteria.

Demand for Mortgages

Once the borrower selects an investment, the borrower may finance the investment with equity, debt, or both.[8] Equity financing of owner-occupied housing is still the dominant form of housing finance in all but the most developed market economies. For example, over one-third of U.S. owner-occupants have no mortgage debt on their homes.[9]

Debt or mortgage finance is usually of most importance at the time of the house purchase. This is especially true for first-time homebuyers because they usually have modest amounts of wealth needed for a downpayment and the purchase price of the house is usually three to five times the size of its annual income.[10] Furthermore, many of these households are ill-equipped to assume interest rate risk.

A successful housing finance system offers assistance to these households by making housing more affordable. The principal benefit is the provision of long-term credit allowing the household to spread the cost of the house over a longer period of time and providing a better match between the cost of the housing and the income of the borrower. Because the housing unit will provide services to the household over many years, the long-term mortgage also provides a better match between the benefits of the investment (the services of the house) and borrower income. Almost all homebuyers in the U.S. use a mortgage to purchase a home and the ratio of mortgage debt to purchase price is usually in excess of 75 percent. The ratio is even higher among first-time homebuyers. In economies with stable and low rates of inflation, the long-term mortgage often has a fixed interest rate; some type of indexing is desirable in inflationary environments.

A potential agency problem exists on the demand side of the market if borrowers have low or even negative amounts of equity in the house, which may occur if the initial down payment is small or if housing prices decline unexpectedly.[11] In such a case, the borrowers incentive to repay the mortgage declines. Lenders deal with the problem by requiring substantial downpayments (equity) and, on occasion, requiring recourse to other assets of the borrower in case of default. Mortgage insurance exists in some countries (notably the U.K. and U.S.). Agency problems may also affect this relationship.

Supply of Mortgage Debt

The supply side of a housing finance system can be described in terms of the *functions* performed by market participants. These functions can be characterized in a number of ways and in various levels of detail. The characterization offered here emphasizes four main functions:[12]

- *Mortgage origination and underwriting:* this includes marketing efforts to recruit borrowers, the establishment of terms and criteria associated with mortgages such as the interest rate, downpayment requirements, and payment to income ratios;
- *Mobilizing a supply of funds:* a bank or other deposit based institution serves this function by collecting deposits from households and firms; a mortgage bank can do this by selling debt instruments to the capital markets or issuing mortgage-backed securities. In both cases, an institution performs the intermediary function between originators and investors;
- *Mortgage servicing:* servicers can be the intermediary, the originator, the ultimate investor, or a separate entity, which is becoming more common in the U.S. In addition to collecting mortgage payments from the borrowers and distributing them to the investors, the servicer also plays a critical role in the monitoring of loan performance and, if necessary, foreclosure. Borrowers, investors, and intermediaries usually put in place systems to monitor the performance of the servicer and reduce potential agency problems.
- *Investment:* Investment refers to the provision of funds for mortgage lending; investors provide the funds to the borrowers and receive their mortgage payments. Investors also suffer losses in case of default. These can include depository institutions, pension funds, insurance companies, the purchasers of bonds or securities backed by the mortgages, and those who provide mortgage insurance.

These functions can be delivered by a wide variety of institutional arrangements.[13] They need not be delivered by one institution nor do they necessarily require institutions that specialize in one or more of these areas. Furthermore, it is becoming increasingly clear that these functions of mortgage finance can be provided in modern market economies without the existence of a single or even a small number of institutions dedicated to provide all functions.[14]

The optimal institutional arrangement depends upon a host of factors. Potential economies of scale and scope are often emphasized as is the development of broader financial markets. We stress another: potential agency problems.

A key factor in the design of the optimal institution is the ability to monitor potential agency problems. Agency problems are minimized in a profit-maximizing institution that performs all of the functions because the agents are likely to be driven by a common incentive or goal: maximize the profits of the institution. Agency costs are likely to be much greater in a system in which the functions are performed by a variety of institutions because each agent seeks to maximize the profits of the institution it serves.

For example, consider the relationship between a mortgage originator and an investor different than the originator. The investor needs assurance that the originator is using acceptable underwriting criteria in the origination process; otherwise, the investor will be stuck with poorly performing loans. The easier it is to obtain such assurance, the more likely the functions will be separated and vice versa.

The U.S. and British systems were based in large part upon a single institution that performed all four functions: the savings and loan association or the building society. The U.S. system has made a transition from a system dominated by a single institution to one in which the functions are delivered by a wide variety of specialized institutions. In this new system, agency problem are addressed by a variety of policies. Investors or intermediaries often dictate underwriting criteria. Investors often require equity participation by mortgage originators, have recourse to the assets of the originator in case of default, and have the technical capabilities to monitor the activities of the originators. These policies coupled with the enormous size of the U.S. mortgage market (Fannie Mae will soon be the first "trillion dollar corporation"), major improvements in computer technology, and the special relationships between Fannie Mae, Freddie Mac, and the federal government are the reasons the U.S. housing finance system has been able to evolve.

Although a secondary market and functional specialization have been introduced in the United Kingdom, housing finance is still dominated by the building societies. Agency problems between lenders and insurers have eroded the market share of centralized lenders (similar to mortgage bankers in the U.S., primarily funded by mortgage-backed security issuance). Mortgage insurers suffered large losses on high LTV loans originated by lenders during the late 1980s. The insurers were subsequently downgraded by the ratings agencies which resulted in a higher cost of credit enhancement for mortgage security issuers.

An important insight arises from these observations: *there is no single or optimal housing finance institutional model that can be applied to all countries at all times.* Like any complex organization, the optimal form of a housing finance system depends upon a variety of factors including profit opportunities available elsewhere in the economy, the prices of various inputs, the technology of mortgage production and servicing, and, importantly, the extent and nature of agency problems. Until the technological and legal systems are in place to monitor and control principal-agent relationships, it would be best for Slovakia and other transitional economies, to avoid the creation of institutions which specialize in one or two mortgage finance functions. Reform efforts should also be wary of placing much reliance on institutions inherited from the previous planning regime: the functions performed by these institutions and the incentives they face do not always match well with the types that operate in a modern market economy, especially if market value of these institutions (new banks) is small or negative.

Instead, such *efforts ought to focus on the development of the economic and legal environment needed to perform the basic functions of a market oriented housing finance system.* This involves assessing the capabilities and interests of existing and emerging institutions and nurturing those with both the interest and potential to provide the functions of a housing finance system. It also involves the development of the broader legal and economic environments in which these institutions operate. In particular, legal barriers to a market-oriented housing finance system must be removed and providers of housing finance ought to be guided primarily by the opportunity to earn profits.

Having expressed these general principles, the optimal configuration of a housing finance system in a transitional economy at this time is likely to be less specialized than the modern U.S. system because of potential agency problems.[15] To demonstrate this proposition, consider the problem faced by a transition economy that may be looking to foreign investors as sources of long-term funds for mortgages. Foreign investors will be seeking strong assurances that originators, presumably locally based, are making good underwriting decisions. The foreign investors will also incur costs to monitor the performance of the originators. If these costs are too large or the originators prove difficult to control, foreign investment will not be forthcoming. In such a case, mortgage originators may choose to alleviate investor concerns by taking equity positions in the mortgages originated, which amounts to a partial "bundling" of the origination and investment functions.

More generally, the cost of controlling and monitoring potential agency costs associated with a highly specialized housing finance system are likely to be substantial given the current situation in many transition economies. More specifically, people have to become more comfortable with the "rules of the game", information technology has to improve, legal consequences better spelled out, and the economic returns to investments better documented and understood. Until these come about the transition to a modern and market-oriented housing finance system should probably begin with a less specialized system and allow market forces and technological improvements dictate the exact shape of the optimal institutional form and the speed at which it evolves.

Market Outcomes

Like any market, the price of the product depends upon both supply and demand. In the case of mortgages, the price of the mortgage is most often considered to be the "effective" rate of interest on a mortgage contract; this includes the contract interest rate and any upfront payments associated with the loan. All else equal, the lower the effective rate of interest relative to the rate paid by the most credit worthy borrowers, usually the government, the better the housing finance system. In addition, positive real rates of interest are essential in order to attract investment funds. The quality of a housing finance system can also be measured by the range of borrowers who have access to long-term mortgages and the importance of government subsidies; the wider the range of borrowers served and the lower the importance of subsidies, the better the system.

Another outcome of a housing finance system is the particular form of the mortgage contract. A wide variety of mortgage instruments exist. Although the most popular in the U.S. is the 30 year fixed payment mortgage, many other instruments exist. These include the adjustable-rate mortgage, the graduate payment mortgage, balloon mortgages, and the shared-appreciation mortgage. The cost of debt in long-term mortgage contracts can also be linked to a variety of indexes. For example, indexes can include measures of the current market rate of interest, the cost of funds to lenders, the rate of inflation, and the average wages of workers.

Indexed mortgages are especially valuable in inflationary environments; however, indexed mortgages are also prone to agency problems. The problem arises if borrowers can exert more political pressure on the government than the investors. In such a case, the government may choose to override increases in the cost of mortgages dictated by the index to which the contracts are linked. Such a possibility exposes investors to political risk that is difficult to hedge and, all else equal, will reduce their willingness to provide funds for such mortgages.

NECESSARY CONDITIONS FOR AN EFFECTIVE MARKET-ORIENTED HOUSING FINANCE SYSTEM

Although the precise institutional structure of a modern and market-oriented housing finance system is not unique, one can certainly identify several conditions or criteria (other than the profit motive) associated with a successful market-oriented housing finance system. These include those necessary for the long-run success of a mature market-oriented housing finance system and those needed to begin the process of reform in a transition economy. Both are the subjects of this section.

Long-Run Conditions

There are many conditions or characteristics associated with a successful housing finance system and many more ways of characterizing these conditions. The following discussion emphasizes four conditions: the legal environment; the motivation for decision-making; links to the broader financial markets; and, a vibrant market for owner-occupied housing. If these conditions are satisfied within an economy, then the chances for the success of a housing finance system are good.

Appropriate Legal Environment

The legal environment includes well-defined property rights for owners, mortgage contracts and laws, and mechanisms by which the contracts can be enforced and monitored. An essential part of this environment in housing finance is the ability to evict the owner-occupant who does not fulfill the terms of the mortgage. More generally, the ability to enforce contracts is essential in order to minimize agency costs.

Stable Macroeconomic Environment

A stable macroeconomic environment includes a low and steady rate of inflation, high levels of employment, low government deficits, positive real rates of return for savers and investors, a broad based tax system, and a healthy trade sector. A housing finance system benefits from such an environment, although few, if any, countries satisfy all of them, even countries with modern and market-oriented housing finance systems. Among the features of a stable economy, the rate of inflation is probably the most important. A high and unstable rate of inflation tends to reward borrowers and penalize lenders and, consequently, discourages long-term investment, which is critical to a successful housing finance system.

Vibrant Market for Owner-Occupied Housing

This is usually the primary impetus for a system of housing finance. Households must have resources and a desire to purchase housing. Suppliers should have opportunities to build new housing in response to demand increases. Also, a housing finance system benefits from and helps support mobility among the owner-occupants. The greater the mobility of the owner occupants, all else equal, the greater is the number of mortgage originations and the greater the opportunity to achieve the benefits of economies of scale and scope.

Close Links to Broader Financial Markets

A modern market-oriented housing finance system is not isolated from the broader financial markets. Mortgages likely comprise one part of a larger portfolio of investments. Some lenders may specialize in real estate, but not all. Similarly, some households may be borrowers of mortgages and others may lend their financial assets to banks, insurance companies, pension funds, and other institutions who, in turn, use the funds to invest in mortgages.

Transition

The discussion to this point is limited to a long-run or optimal housing finance system. Another essential part of a discussion of housing finance is the period of *transition* from a planned economy to a market-oriented system. In this regard, two points seem essential and worth noting: the timing of the reforms matters and the presence of agency problems within the housing finance system can be a source of problems.

The Timing of the Reforms Matter

It is possible to move too quickly. Reforms in other parts of the economy are required in order to begin substantial development in the housing finance system. In particular:

- *Macroeconomic Reforms.* It is widely accepted that housing finance systems perform better in stable economic environments. This environment is characterized by low and moderate rates of inflation, near full employment, positive real interest rates, and stable and predictable fiscal policies. The reasoning is simple. Potential investors are unlikely to provide funds for long-term mortgages if the expected return is subject to considerable uncertainty.

- *Housing Market Reforms.* A successful housing finance system is part of an efficiently operating housing market. Rent should be freely negotiated, with the majority of tenants paying market determined rent. Land development and construction must be possible without excessive delay or costs. Labor and materials for construction ought to be readily available at a reasonable and stable cost.

If reforms in the macroeconomy and housing market are incomplete, reforms in the area of housing finance are likely to be unsuccessful.

Agency Problems Are Among the Most Difficult to Be Resolved

Transition economies share a common problem: how to transfer responsibility for the allocation of economic resources from the government to private parties. Until this is done, resource allocation decisions are likely to be dominated by political rather than market-driven economic criteria.

This problem is particularly acute in the banking sector of the transition economy because all banks were agents of the government in the previous regime. Although privatization of banks is underway in most transition economies, governments are generally unable or unwilling to completely privatize them. The market values of these banks are often negative because of poorly performing and low interest loans on their books, which makes it difficult for government to attract private investors to purchase shares in the banks. As a result, effective government ownership remains high. Furthermore, the low amounts of capital and political considerations provide managers of the banks to take excessive risks.[16]

Housing finance reforms can proceed without the complete privatization of all financial institutions, but the speed, quality, and nature of the reforms are related to the progress of the reforms of financial institutions. The slower the transformation of the financial institutions into truly private institutions with adequate capitalization, the greater is the temptation to use the "government" banks to execute housing finance reforms, which is likely to be a risky and unsuccessful alternative. Government can avoid this temptation by speeding up the privatization and restructuring of banks, encouraging the creation of separate and solvent subsidiaries of the government banks, and relying upon truly private and foreign-owned banks to lead the development of the housing finance system.

THE SLOVAK CONTEXT

An overview of the Slovak economy, banking system, housing sector, and legal environment is offered in this section. The review and the assessment draw upon information collected during two recent USAID funded missions to Slovakia. The review also draws upon the analysis of various literature and statistics made available to us by the Slovak banks and the government. (In the fall of 1993, one U.S. dollar could be exchanged for 30 Slovak crowns).

Economic Environment

The economic transformation of Slovakia has been similar to that in other former socialist states, where output initially dropped precipitously and inflation rose due to price liberalization and a change in import orientation. Today, Slovakia's economy is characterized by a slow recovery from its transitional recession. On a macroeconomic level, GDP declined by 7.4 percent in 1993. The inflation rate has been relatively high with a 16 percent annual rate in 1992 and a 25 percent annual rate at the end of 1993.[17] In addition, the unemployment rate has been rising, from 10 percent in 1992 to a 18 percent in 1993. The government is running a budget deficit in the range of 5 percent of GDP (or Sk 16 billion at the end of 1993) and significant revenue shortfalls continue to put pressure on the budget. A substantial trade deficit was experienced in 1993, primarily reflecting the sharp reduction in trade with the Czech Republic after the "velvet divorce" at the end of 1992 [Nomura Research, 1993].

There are reasons, however, for optimism because Slovakia appears to be moving in the direction of macroeconomic stability. Slovakia has a very low foreign debt burden (the lowest of all Eastern European countries) and has been experiencing a rising trade surplus with the West (Germany, followed by Austria and U.S.). The underlying inflation rate is moderate and stabilizing (forecast to be 16 percent in 1994). It is also notable that the government has reached an agreement on economic policy with the IMF limiting the budget deficit to 5 percent of GDP and M2 growth to 19 percent. The so-called soft budget constraint to former state enterprises has been hardened and a bank-

ruptcy law was passed in mid-1993 which may end the practice of extended supplier credits between enterprises. On a microeconomic level, all prices have been decontrolled, except for rent and some utilities and public transportation, and considerable progress has been made in privatizing former state enterprises through a voucher privatization scheme first initiated when Slovakia was part of the former Czechoslovakia.

On the other hand, there are significant uncertainties about the continued success of the reform effort. Slovakia is home to many of the former Czechoslovakia's obsolete state enterprises, especially the heavy arms industries. Until the future of many large former state enterprises is determined the macroeconomic environment will remain unstable. In particular, unemployment in Slovakia may rise due to massive layoffs caused by enterprise restructuring. This situation has two effects on the financial system. On the liability side a large portion of savings are likely to be held in cash or short term accounts for precautionary reasons.[18] On the asset side, the potential deterioration in credit quality of the enterprise borrowers may lead to large loan losses and capital impairment of the banks.

Slovakia's Banking System

Since the division of Czechoslovakia, the Slovak financial sector has suffered from imbalances in regional development, capital concentration in the former state banks, and the lack of development of regulations and laws affecting various banking activities conducive to long-term lending. A two-tiered banking system in Slovakia was formed with the break-up of the Czechoslovak federation in January 1993. This split resulted in the division of assets of the former Czechoslovak State Bank (by a 2 to 1 ratio, favoring the Czech republic) and a new Slovak banking law (The Banking Act, No. 21/1992) allowing for the establishment of a central bank, the National Bank of Slovakia (NBS), and commercial banks. Though the establishing legislation conforms to a Western model, the new banks have been slow to undertake the financial activities required by an economy undergoing restructuring as it transforms itself from a planned system to one oriented towards markets.

The liberalization of the banking sector in Slovakia began in 1989, when the former Czechoslovakia shifted towards a democratic and market oriented state. With the advent of the first banking reforms, the former Czechoslovak State Bank took on the role of a traditional central bank and two commercial banks were formed, one for each republic. Some assets and liabilities, including subsidized housing loans, were transferred to these newly created commercial banks. The State Savings Bank, which long held a monopoly as the depositor of household savings, became a commercial bank with little expertise in market lending practices. With the (state) creation of the first commercial banks, the banking system diversified in the former Czechoslovakia, though imbedded in balance sheets of these newly formed state supported institutions were subsidized consumer and enterprise loans.

At the end of 1993, 17 commercial banks operated in Slovakia, representing an increase of 11 banks over a one year period. Most of the new commercial banks were formed as joint stock companies with an initial working capital (up to 30 percent in the form of assets) of Sk 300 million - the minimum capitalization requirement.[19] Of these newly established banks 9 are foreign owned; 8 are Czech branches while one is Dutch based. Collectively, there were 1,007 bank outlets in 1993 located through-out the country for Slovaks to conduct their banking. All but two of the banks are licensed to offer a full range of banking services (universal banks) while the National Bank of Slovakia granted foreign currency authorization to only 6 commercial banks.

Relative to the needs of the economy, the 17 commercial banks in Slovakia are cash poor. The rate of growth in deposits was less than the inflation rate over the 1992 to 1993 period. The commercial banks are also relatively illiquid and have significant concerns about liquidity risk. The total subscribed basic capital of commercial banks in mid-1993 was Sk 11,706 million, growing by only 6.1 percent in 1993, which is less than the rate of inflation over the period. Despite these concerns, over 42 percent of total loans are over 4 years in maturity. Figure 1 shows the structure of Slovakia's banks deposits and credits by sector according to term in mid-1993.

Figure 1 shows that the majority of deposits held by both institutions and households are in short term deposits and paid a dividend of 10.7 percent interest, just below the inflation rate during this period. Household deposits accounted for 96 percent of the long term (greater than 4 years) deposits, held mainly in the Slovak Savings Bank. Not surprising for an economy where 21 percent of GDP is generated by private firms, 15 percent of all short term deposits were held by the private sector. As in most market economies, Slovak banks paid a 3 percent premium for long-term funds, though these amounted to only Sk 6,515 billion or 3 percent of all deposits held by banks.

Figure 1 further shows, that most bank credits were short term (less than one year), mainly targeted to state enterprises (67 percent). Again, privatization has helped to boost the short term borrowing requirements of non-state firms, in the short run as well as the long run. Almost one third of all loans were directed to the private sector, with roughly 40 percent given out as long term credit. State enterprises account for about 50 percent of all long term credit, which mainly represent past loans dispensed by the former state banking institutions. The lending rate exceeds the short term deposit rate by almost 8 points, and undercuts the inflation rate by approximately 4 percent points.

A nascent money market is also slowly emerging in Slovakia. Two new capital markets were established:

- the Stock Exchange of Bratislava (BBCP), and

- the Option Exchange of Bratislava (BOB).

The Stock Exchange of Bratislava is joint stock company with 10 Slovak financial institutions as its shareholders. Trading commenced in April 1993, in 14 day intervals. Initially established with Swedish assistance, the Bratislava Option Exchange organizes trading with options and futures in securities and acts as clearing center for such trade. Due to inconsistencies in the establishing laws and general lack of capital, neither stock exchange has been able to mobilize significantly large financial resources to generate long-term investment.

At this point in time there are no real housing finance circuits in Slovakia.[20] In 1992 two contract savings institutions modeled after the Bausparkassen in Germany were created. Savers have two incentives for opening these accounts. The state will credit the account with an amount equal to 25 percent of the annual savings, up to Sk 18,000. Also, the interest on the savings is exempt from income tax. However, they will not be active lenders for two years (the minimum time for a savings contract to be open before a loan can be granted). Furthermore, The ability of these schemes to provide meaningful funding for housing is severely undermined by inflation.

Housing

Housing policies have changed significantly in Slovakia. The government is no longer subsidizing the interest rates on new housing loans and has terminated grants on new housing projects. In addition, ownership and management of former state owned housing was transferred to municipalities as of mid-1991. The government unsuccessfully attempted to float a bond issue to provide funds to municipalities for infrastructure projects. There are a substantial number of unfinished housing projects (estimated to equal approximately Sk 18 billion) and on-going discussion about providing funds through international aid agencies to complete some of them. Explicit and implicit subsidies now incurred by the municipalities to maintain and operate rent-controlled housing exert a significant hardship on cash-strapped local governments.[21]

The two cornerstones of socialist housing policy, rent control and tenant property rights, remain firmly in place. Although rents for existing units increased by 100 percent in mid-1992, they still remain below operating costs and do not provide the cash flow necessary to support needed renovation and improvements. The continued presence of rent control in the existing rental housing stock and the requirement that landlords provide alternative housing to a tenant that is being evicted undermines the attractiveness of rental housing investment. Although rents have been decontrolled for new construction, the threat of its imposition and the practical inability to evict increases perceived development risk. In addition, uncertainty over land ownership has delayed the start of new projects and municipal governments lack the resources to provide the necessary infrastructure.

Change also has been slow in the owner-occupied sector. Although 50 percent of the housing stock is owner-occupied, most of it is in rural areas or on the outskirts of large cities (e.g., single-family homes owned by households with rent controlled apartments in town). There is a relatively large cooperative sector (approximately 23 percent of the stock) which may become owner-occupied housing in the near future. Rentership is most dominant form of tenure in urban areas. For example, almost 60 percent of all housing in Bratislava, the capital of Slovakia, is renter occupied, the remainder, except for the 9 percent of households who own, is cooperative housing.[22]

One reason for the slow development of the

Figure 1: Structure of Bank Deposits and Credits by Sector in Billions of Slovak Crowns

	Short Term (<1 year)	Medium Term (1-4 years)	Long Term (>4 years)	Total
Deposits :				
Average Deposit Rate	10.7%	13.0%	13.0%	
Enterprises	26,489	245	319	27,059
Financial Institutions	2,342	13,068	0	15,410
Households	69,369	31,116	6,198	106,683
Private Sector	19,198	990	1	20,189
Other (govt. non-profits etc.)	17,020	1,319	0	18,340
Total	**134,427**	**46,738**	**6,515**	**187,681**
Credits :				
Average Lending Rate	18.2%	15.8%	9.8%	
Enterprises	62,816	18,883	49,560	131,260
Financial Institutions	0	15	0	15
Households	1,375	7,712	19,945	29,032
Private Sector	27,994	21,131	33,372	82,497
Other (govt. non-profits etc.)	594	1,133	1,883	3,611
Total	**92,779**	**48,874**	**104,760**	**246,417**

Source : National Bank of Slovakia, June 1993

owner-occupied market has been a lack of mortgage credit. The government has ended its provision of low interest mortgages but a private sector housing finance system has yet to develop. Owner-occupied housing is not viewed as acceptable collateral for lending, as a lender cannot obtain possession of a unit from a defaulted borrower without provision of substitute housing (as in the case of rental eviction). Commercial banks other than the savings bank are relatively illiquid and reluctant to extend long term credit.

The slowness of change in the rental housing sector reflect the political sensitivity of moving rapidly away from the socialist system of guaranteed tenure and low cost housing. However, the lack of progress in this sector has significant effects on the sustainability of the broader transformation process. Rents below operating costs exert an on-going drain on government budgets, crowding out expenditures on essential infrastructure maintenance and development. The distortions caused by rent control mask the true demand-supply balance in the Republic and allow proposals for new state subsidized construction to proceed without a true understanding of their need. Rent control acts as an impediment to labor mobility, an important factor in a transforming economy. It is also a highly inequitable form of income redistribution. providing benefits to households based on where they live and not on their income or wealth.

Legal Environment

The lack of a legal infrastructure conducive to collateralized lending is a major impediment to the development of a housing finance system. A legal system that defines the rights of the mortgagor and mortgagee, includes a process for foreclosure and repossession and allows eviction of defaulted households is an essential prerequisite for housing finance. In addition, an efficient and accurate land registration system is necessary to ensure low cost and low risk transfers of real estate and establish the rights of lenders.

The legal basis for mortgage lending essentially disappeared under the socialist regime in the former Czechoslovakia. Housing costs were low and lending rates were highly subsidized under socialist housing policy. As a result mortgage default and rental arrears were quite low. Foreclosure, though legally possible under the terms of the civil code, was not a viable option due to the near impossibility of eviction. Because both banks and enterprises were state owned, wage garnishment could be used to satisfy overdue payments, though this rarely occurred because of low, subsidized costs. Lenders in theory can take mortgages on real property and register them in the land registry. However, the impossibility of evicting tenants or defaulted borrowers has caused lenders to refrain from mortgage lending or require the pledging of other forms of collateral to secure a loan. The rise of small, private businesses has lessened the use of wage garnishment as a form of security.

AN INITIAL AGENDA FOR HOUSING FINANCE REFORM

Is the time right to launch a major housing finance initiative in Slovakia? By a "major" initiative is meant the establishment and funding of a new institution responsible for providing large amounts of mortgage financing to the people of Slovakia. An example of such an initiative is the establishment of a government-sponsored or guaranteed conduit such as the U.S. Fannie Mae. Funding a large-scale system of insured indexed mortgages is another example of what we mean by a major initiative.

Our sense is that the time is not right for two major reasons. First, most of the conditions under which a housing finance system can be expected to prosper are not currently satisfied in Slovakia. Improvements in the stability of the macroeconomy, the legal environment, and the pace of reforms needs to be increased. The stability of the government is another major factor. For example, the recent vote of "no confidence" in the previous regime probably makes potential long-term investors less interested, at least in the short-run.

Second, the preferred institutional form for a housing finance system in Slovakia is not yet clear. A variety of options exist and the ultimate, preferred institutional form depends upon a variety of factors as yet undetermined. At the current time, the incomplete state of prior market and legal reforms, the limited size of the market for mortgages, and inadequate experience with a market-oriented housing finance system probably favors a less specialized system of housing finance than exists in the U.S. Our principal concern is that potential agency problems are too great to permit the effective functioning of a highly specialized system. The government may want to begin some modest reforms along these lines, which are mentioned below, but the government should also maintain its flexibility in this area for several more years.

Although it is too soon to launch a major initiative, an incremental approach does seem appropriate. Broadly defined, the incremental approach includes efforts to develop the general conditions appropriate for a modern and market-oriented housing finance system and several specific reforms targeted toward housing finance. Seven areas of this reform effort are particularly important.

Improve the Legal Environment for Housing Finance

Steps ought to be taken to develop a legal system in which a mortgage contract can be enforced. This involves improvement of the laws relating to the eviction of borrowers who default on their loans. It also involves policies relating to the monitoring of ownership rights and the enforcement of them.

Continue Efforts to Stabilize the Macroeconomic Environment

Reductions in inflation and the size of government deficit remain among the most

important steps that can be taken to develop a market-oriented housing system. In this regard, those responsible for housing policy should expect a continued decline in the subsidies available to them and use them wisely. Using such subsidies at this point to promote a housing finance system is probably not the best use of them.

Continue Efforts to Promote a Market-Oriented Housing System

Privatization of the housing stock and decontrol of rents are a high priority. Without these reforms most households will lack the resources and incentives to support a vibrant market for owner-occupied housing.

Encourage the Development of Mortgage Lending Institutions

Continued privatization of the banking sector is another high priority; especially important is the development of several organizations with the expertise needed to perform one or more of the functions of a housing finance system. One possibility is the establishment of new subsidiaries of the three major government related banks with sufficient capital and incentives to begin some mortgage lending. This may require the forgiveness of some old and unprofitable loans and the infusion of new capital. A key to encouraging greater mortgage lending by both existing and the new private banks is the prospect of positive real after-tax returns. Thus, efforts to make housing investment more profitable (e.g., relaxation of rent control) and access to collateral easier (e.g. reasonable foreclosure laws) may be the most effective ways to stimulate activity. What is crucial is that the institutions be driven by market criteria and that contracts, policies, and organizational structures be developed to minimize the potentially dangerous agency problems of the type emphasized in this paper.

Begin a Dialogue with the European Community Regarding Housing Finance

Of particular interest is the possibility of obtaining long-term funds from other European investors. As noted above, the likelihood of this happening in the near term is low because of investor concerns about the stability of the economic and political situation and potential agency problems; nonetheless, steps can be taken to allay some of these fears and gauge the interest and requirements of foreign investors. One possibility uses the contract savings scheme in conjunction with funds provided by foreign investors. For example, the contract savings scheme would originate second mortgages to its customers and seek funding for first mortgages from foreign investors, perhaps funded through mortgage bonds backed by investors in the European Union.[23]

Encourage Development of a Bond Market

One of the major issues in funding housing is the absence of long-term funds, as for the case of Slovakia. As the transformation proceeds, emphasis should be given to the mobilization of long-term savings (e.g. through pension and insurance plans). Institutions mobilizing such funds are natural investors in long-term assets such as mortgages. Development of mortgage-backed bonds can provide a vehicle for their investment. Providing marcoeconomic stability and an appropriate tax and regulatory environment are perhaps the most effective ways the government can encourage bond market development. Policies in this area must also produce a "level playing field" for mortgages and other assets by avoiding excessively generous tax incentives (e.g. for municipal bonds) or requirements for investors to allocate a certain portion of their portfolios to particular assets, regardless of risk-return characteristics. ■

NOTES

[1] The views, expressions and opinions contained in this paper are the authors' and are not intended as statements of policy by the United States Agency for International Development (USAID), which partially funded this paper.

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tion and insights provided by several members of the Slovak Government is also much appreciated; these include Ivan Hrncar and Lubor Cuda.

[4] McKinnon (1991) and Thorne (1993) discuss financial reforms. On housing reform, see Baross and Struyk (1993), especially the paper by Kingsley, Tajcman and Wines. See also Bertrand Renaud (1991).

[5] One recent example is Buckley, Hendershott and Villani (1993).

[6] This is a quotation from a recent speech by Klaus; excerpts of the speech were published in a World Bank publication entitled *Transition : The Newsletter about Reforming Economies.*

[7] Other goals include : stimulate housing demand; boost employment in the construction industry; promotion of savings; promotion of home ownership; promote capital market development; and, promote labour and capital mobility.

[8] The criterion most widely used to determine whether an investment is appropriate in a market-oriented economy is the net present value (NPV) criterion. NPV refers to the discounted present value of all income (rent, capital gains, tax benefits) and costs (downpayment, operating costs, depreciation, taxes etc.) associated with a housing project. Investors should invest in the project if its NPV is positive; otherwise, the investment should not be undertaken. Investments by owner-occupants must take into account the monetary value of the services provided by the housing unit.

[9] The source of information about US residential finance is the *Census of Housing, 1980 Census of Housing, Volume 5 : Residential Finance,* November 1983.

[10] A mortgage is a loan in which the housing unit is offered to the lender as collateral in case of a borrower default on the terms of the mortgage.

[11] This is also described as a moral hazard problem. McKinnon (1991, Ch.7) provides a good discussion of this issue.

[12] Follain and Zorn (1990) provide a fuller description of these functions.

[13] The US historically relied upon a system in which one particular institution - the S&L - performed all of these function; now it relies primarily upon a securitization system with significant functional specialization. Western European countries use a variety of systems including building societies, the large mortgage bank and contract savings schemes. Recent trends suggest the securitization model has not progressed as well in Europe but the mortgage banking model has existed in Denmark, France and Germany since the 1800s : see Diamond and Lea (1992). A variety of other formal and informal institutions can be found in Latin America and Asia.

[14] For example, financial markets in advanced market economies are capable of absorbing large amounts of interest rate risk so a separate housing finance institution charged with the responsibility of absorbing interest rate risk is unnecessary.

[15] A single institutional form does not mean a single firm. The benefits of competition suggest the need for multiple firms even if a single institutional form dominates, e.g. US thrifts.

[16] Similar problems arise if the former enterprises of the state have major ownership stakes in the banks. To the extent these "privatized" enterprises still have large numbers of employees and considerable political power, the bank will be subject to political pressures.

[17] The inflation rate was helped along by a one time increase of the VAT at the beginning of 1993, a one time 20 percent import adjustment surcharge, and an early year devaluation of the Slovak Crown.

[18] For example, only 3 percent of deposits are over 4 years and only 28 percent are over 1 year (National Bank of Slovakia, 1993).

[19] The two former state banks, The General Credit Bank (VUB) and Investment and Development Bank (IRB) are classified as joint stock companies, but in fact are still subject to state control. The National Property Fund (NPF), a government institution, owns the majority of stock in each bank, and, additionally, some members of VUB's board are also government officials.

[20] Loans to purchase residential property are obtained only on commercial credit terms, usually for about 4 years at about 20 percent interest.

[21] Mikelsons, M, *Housing Allowances : Assessing the Potential for Slovakia,* (1993).

[22] Cooperative housing was initially established under a partnership between the coop, the state financial institution, and the prospective tenant. One third of the cost of the housing was contributed by the coop, one third was obtained through a subsidized state loan, and one third was contributed by the household. Given this type of arrangement, Coops were a desired form of tenure, since the housing was transferred to the tenant once the loan was repaid.

[23] This would have similarities to the German housing finance system. ■

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yond the development of sector institutions. ■

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