The Development of the Mortgage Market in the Czech Republic

by Eva Maříková Leeds

INTRODUCTION

The housing industry in the Czech Republic is in recession. The state has abandoned its role as a supplier of housing and little has filled the void. The government is acutely aware of housing problems and is pinning its hopes on developing a healthy mortgage market to translate the need for housing into effective market demand. This paper describes the history of long-term credit in Czechoslovakia and presents the changes adopted since 1990. It analyzes the current issues and prospects facing the mortgage market.

HISTORY OF THE MORTGAGE MARKET

After World War I the mortgage finance system in Czechoslovakia was an extension of what had existed in the Austro-Hungarian Empire. Mortgage banking was distinct from commercial banking, as it is currently in Germany. It was practiced by state-chartered nonprofit mortgage banks (analogous to Landesbanken). The mortgage banks had no capital, but their obligations (mortgage-backed bonds) were guaranteed by the state. Mortgage banking was well developed, as the traded obligations of the largest mortgage bank were 10% of the government's budget and more than 2% of all deposits. Savings cooperatives and credit unions also extended mortgages.

Eva Maříková Leeds is a member of the Department of Economics at Widener University, Chester, Pennsylvania. She is a former advisor to the Minister of Economy of the Czech Republic. This paper is an updated version of an article that appeared in *The Financier*, Vol. 2, No. 1, February 1995.

In October 1945 all banks in Czechoslovakia that were joint-stock companies were nationalized, and their number was reduced to two after the Communists took over the government in 1948. Law 31/1950 combined the two banks with the central bank and with another institution into Státní banka československá (State Bank of Czechoslovakia), which thus became a monobank of commercial and central banking.

The number of mortgage banks had already been reduced in 1941. Law 183/1948 created the Investment Bank out of a discount bank (i.e., a bank specializing in discount loans) and the three remaining mortgage banks. The Investment Bank was to offer and supervise all long-term credit, but this function was taken over by the State Bank in 1958, and the Investment Bank's activities became relatively marginal.

Savings cooperatives and credit unions, the oldest one dating from 1824, were combined into Státní spořitelna (State Savings Bank) after 1948. In 1968, when Czechoslovakia became a federation of the Czech and Slovak Socialist Republics, the State Savings Bank split into Czech and Slovak State Savings Banks. Both banks continued to channel savings into the State Bank.

After 1948 the state took over both the construction and financing of apartment houses. After 1958 it began building the now-infamous panel constructions, which are high-rises made out of concrete slabs. Housing-building cooperatives, however, were providing twice as many finished apartment houses as the state after 1970.

According to a still-valid but no longer used later regulation (136/1985), the State Bank extended up to 40-year term credit at 1% interest for cooperative housing, and the two state savings banks extended up to 40-year term credit at 2.7% for individual construction, mostly family houses.

After Communism

On January 1, 1990, following the fall of communism, the State Bank was split into a Central Bank and one commercial bank for each republic, Komerční banka (Commercial Bank) and Všeobecná úverová banka. Some accounts, in particular all long-term housing credit, were transferred to the Investment Bank. The Investment Bank was a Czech institution, the Slovak branches having been incorporated into the State Bank in 1968. Its newly opened post-1989 Slovak branches split off in February 1992, and the Investment Bank became once again a Czech institution.

Privatization in Czechoslovakia started in the spring of 1990. The Czech State Savings Bank was chartered as a joint-stock company and renamed Česká spořitelna (Czech Savings Bank). Both the Investment Bank and the Czech Savings Bank were partly privatized in the first wave of the voucher privatization program in 1992. As of January 1, 1994, the Investment Bank, now the Investment and Postal Bank, is owned by the Fund of National Property (34.4%), Investment (mutual) funds (53.5%), Restitution Investment Fund (6.7%) and individuals (5.4%). The Czech Savings Bank is owned by the Fund of National Property (45%), Investment (mutual) funds (37%), Restitution Investment Fund (3%) and individuals (15%). The state holds a golden share in both institutions, which gives it veto power over strategic decisions. Irreconcilable differences between Czech and Slovak political leaders led to the split of Czechoslovakia into Czech and Slovak Republics on January 1, 1993.

The Investment and Postal Bank and the Czech Savings Bank still hold their low-interest long-term loans, now amounting to 23 billion Czech Crowns (Kč). To help the banks, the government supplements the interest payments on the loans. This raises the rates received by the banks to the discount rate, which reached 8.5% in November 1994 after staying at 8% for over a year. The interbank deposit rate, called the PRIBOR, fluctuated around 11% in November and 12% in December 1994.

The supplementary payments, totaling Kč 2.1 billion, are projected to last until 2034, but they will decline with maturing loans and prepay-

Exhibit 1. Contract Specifics, Ownership and Date of Creation of Building Savings Banks

Savings Bank	*Interest Rate[1] on Deposits/Loans*	*Repayment Period (years)*	*LTA[2]*
Českomoravská (55% Investment & Postal Bank; 45% Schwaebisch Hall; September 1993)	3% and 4.5/6%	8, 12, 17	50%
Všeobecná (51% Komerční Banka; 35% BMW Holding; 14% Česká spořitelna; December 1993)	3% and 4.5/6%	8, 10, 12	60%
Wuestenrot (branch of Wuestenrot, Germany; November 1993)	3% and 4.5/6% & 7.5%	9.5, 9, 12	60% & 50%
CS (60.5% Česká spořitelna; 39.5% Bayerische Landesbank; July 1994)	4/6%	8,10	50%
HYPO (60% Hypo Banka Praha; 40% Heimstatt Bauspar AG Muenchen; October 1994)	3/6%	11	55%
AR (51% Agrobanka; 49% Raiffeisen Bausparkasse; September 1993)	3% and 4.5/6%	8, 13, 18, (21)	50%

[1] The higher deposit rate is paid if the saver gives up the right to a loan. In the case of Wuestenrot, the higher rate may apply to anyone. If a depositor wants a loan, however, he must repay at 7.5%.
[2] Percent of loan to the target amount of the contract.

Source: *Jasminsky and Polivka*

ments. The condominium law (72/1994) requires that cooperative members repay the state loan if they wish to own their apartments. The supplementary payments have been covered by the Fund of National Property, which holds property and land to be privatized. In 1995, however, they will be covered by the state budget, of which they represent roughly 0.5%.

RECENT CHANGES AND INNOVATIONS

Credit Markets

The Czech economy, like all transition economies, experienced a recession after 1989, from which it has just emerged. Unlike other countries, the Czech Republic has been careful to avoid runaway inflation. Inflation, when measured by the growth of CPI, peaked in 1991 at 56.6% and is now under 10%. Thus, the interbank deposit rate and rates on term deposits with maturities exceeding six months, have remained above the inflation rate. This environment is conducive to the development of long-term financial markets.

Long-term credit and financing, however, are still in their infancies. The longest quoted Treasury bond has a five year maturity. Most commercial loans also have maturity of up to five years, but their rates, sometimes tied to PRIBOR, may be renegotiated. Several dozen corporations and municipalities have issued fixed-rate bonds of up to 10 years; about two dozen are traded on the Prague Exchange. For example, the town of Smržovka issued seven-year obligations worth 200 million Kč (about $7 million) at 14.25% to finance 70 houses and 40 apartment units. They were underwritten by the Czech Savings Bank, which has also extended municipal credit of up to 10 years. This credit, however, represents a negligible fraction of its portfolio.

Mobilizing long-term capital depends on both favorable macroeconomic conditions and institutional developments. The Czech state will continue to provide basic social security, funded from wage taxes, to all citizens. The government intends to keep payments low. Citizens who want higher pensions may allocate additional savings to private supplemental pension plans subsidized by the state. Law 42/1994 created the framework for private pension funds which, the government hopes, will become one of the chief holders of mortgage-backed bonds.

Building Savings

The contract. The only fully operational component of Czech housing finance policy is "building savings" (stavební spoření, equivalent to the German Bauspar or the French Epargne-Logement) offered by "building savings banks (stavební spořiteiny, equivalent to Bausparkassen in Germany). The law that created them (96/1993) went into effect April 1, 1993. Building savings banks are designed to stimulate private initiative to satisfy housing needs. This innovation stood alone for two years, in part because it was passed at the initiative of Parliament and not as part of a coherent government program.

Six building savings banks now offer building savings contracts. Exhibit 1 gives the details of the different contracts and specifies the details of the different contracts and specifies the ownership structure of each of the six banks. A typical contract is an agreement between a saver and the bank that guarantees a loan after a five-year or longer savings period. The saver contracts to make regular deposits that—together with a state bonus—imply a given future amount in year five. In the fifth year or later, the saver is entitled to a loan, usually equal to the amount he has saved, which becomes a downpayment. He can obtain credit earlier with the corresponding number of annual bonuses if he accumulates the future amount and attains a given index number based on his earned interest and rate of saving. He must save for a minimum of two years, however, to obtain credit.

Deposits earn below-market interest, commonly 3%, and loans are repaid with a margin of up to 3% over the deposit rate for a period of eight to 18 years. The future amount and the loan comprise the "target amount." (The minimum monthly deposit is 0.5% of the target amount.) Loans start at Kč 5,000–25,000 and have generally no maximum. They are limited to housing in the Czech Republic and may be used only to buy or build a house or an apartment (including land) or to make repairs and improvements.

To induce savings, the state adds a bonus of 25% of new annual savings up to Kč 18,000, making for a maximum payment of Kč 4,500 per year. This lump sum is payable every March. All permanent residents (even minors) are eligible for one state-supported savings contract at a time. The bonus is crucial for the attractiveness of the contract. Without it, the cost (low deposit rate) may offset the benefit (low loan rate) of the contract.

The law set the bonus to reflect market rates. In late 1994, the nominal rate on two-year deposits was 12%, and the after-tax rate of return was 10.2%, because all deposits are taxed at 15%. Building savings are not taxed. Monthly savings deposits under Kč 1,250 are attracted to building savings because the 3% return and the state bonus create an internal rate of return of 12.1%, which exceeds the market rate by 1.9%. With monthly savings deposits of Kč 1,800, the maximum state bonus becomes relatively small. The internal rate of return drops to 10%, below the two-year after-tax rate of return. Large building savings are thus attractive only to those who need a loan quickly. Building savings are less liquid than term deposits because early withdrawal, even in the fifth year, triggers the loss of all bonus payments.

The bonus is given to all savers who make regular deposits for five years, regardless of whether they later take out a loan. After five years they may withdraw the saved amount and use it for any purpose. Savings banks must include savers who do not desire a loan to equalize the sources and uses of funds. Loans are repaid relatively slowly, and the bank needs extra sources of funds to continue making loans. The system thus depends on either an increasing number of savers who want a loan or a number of savers who do not want one and whose savings are used to fund loans.

System comparisons. In terms of the sources and uses of funds, the Czech system is closer to the French than the German system. The German system is closed, which means that loans are restricted to participants and funded strictly from participants' deposits. If deposits slow down, a waiting period—which can exceed one year—for loans develops, and loans must be rationed.

In Germany, "imbalances between available funds and loan commitments are regulated . . .by a well-publicized point system, plus explicit negotiable features trading off loan size and priority in the queue . . . Savers with the largest regular deposits and . . . borrowers selecting the shortest loan maturities . . . are first in line to get a loan."[1] The saver who becomes eligible for a loan but does not take it does not lose his priority.

The French system is open, which means that deposits are accepted from savers who do not need loans (bons frères). Deposits may be used for other types of housing loans and for mortgage bonds if they exceed the amount needed for loan commitments. Openness is facilitated by the fact that any deposit bank can issue building savings contracts. The Czech system limits the uses of funds but not as strictly as the German system. The sources of funds are open, as in the French system. If the government keeps the savings rate competitive by adjusting the bonus, no waitiing periods will develop for loans.

The only way to change the bonus to respond to market conditions is by amending the building savings law, which is rather cumbersome. The law should contain a formula which links the size of the bonus to market interest rates. If the bonus stays inflexible, building savings banks may develop liquidity problems. If the interest rates drop, as the government hopes, then the building savings banks will be flooded with deposits. Should the rates rise, the bonus will be insufficient, and the banks will be short of funds.

Recent developments and portfolios of building savings banks. In November 1994 building savings banks began to offer interim "bridge" loans of up to three years for savers who were not yet eligible for the contract loan but who had saved at least 30%–40% of the target amount. Such loans correspond to the German "zwischen" loans. By September 1995 the six banks made about a thousand bridge loans, charging on average 12%. Some banks have recently lowered the rate but have increased the required savings. The loans are backed by a lien against property and are repaid with proceeds from the building loan when the saver becomes eligible.

On April 18, 1995, Parliament passed a building savings law amendment that became effective on July 1, 1995. Most of its provisions are technical, but four are substantive. The first one makes building savings contracts without the state bonus available to firms, cooperatives and municipalities. The government hopes the extension will increase the flow of funds into building savings banks. (See below for the remaining provisions.)

Building savings banks have highly regulated portfolios (Article 9, law 96/1993). They may extend other housing loans, such as bridge loans, provided they first meet all contract savings obligations. Other loans must not lengthen the waiting period for contract loans, and the outstanding amount of other loans must not exceed 40% of deposits. In addition to collecting contract deposits, savings banks may borrow and issue obligations.

The second provision seeks to increase the percentage of other loans, particularly in the start-up period before low-rate loans may be offered. Building savings banks are allowed to hold equity in companies in the housing industry—up to 15% of their own equity and one-third of the equity of the parent company. They may extend credit to housing-industry companies, as well as hold and trade Treasury obligations and make deposits at other banks. The third provision limits the maturity of obligations to five years, as was the case in Germany until recently. The new limitation is not very important, however, because—if Germany is an indication—only a minuscule fraction of liabilities is funded through bonds. Building savings banks have the same capital requirements as commercial banks. The fourth provision restricts savers who take out loans earlier than in five years. They must use their accumulated savings only for housing needs; otherwise, they lose the state bonus.

Since building savings banks were established in late 1993, banks made the first contract loans in late 1995. The state has sought to move up the date at which depositors take out loans by encouraging them to save quickly. It promised the full annual bonus to all savers who deposit the full annual contract amount by the end of each year. For savers who do not need a loan, a lump-sum deposit at the end of the year lowers the internal rate of return on savings because they must keep the account open for five years to receive the bonus.

The effect of building savings cannot yet be fully evaluated. While they have become popular—as of December 30, 1995, close to 1 million accounts had been opened—their incidence still pales compared with that in Austria, Germany and France, where approximately one out of two or three citizens participate. Only 2% of aggregate savings are in building savings accounts. (For comparison, the Czech Republic has 10.3 million inhabitants, but the programs in Austria, Germany and France are significantly older.) Participation rates will remain limited as long as housing is not generally affordable in the Czech Republic.

Building savings are not large enough to increase the demand for housing significantly, because the average annual saved amount is only Kč 10,000. Alternatively stated, the average target amounts for most building savings banks are between Kč 130,000 and 140,000 and Kč 210,000 for Vseobecna stavebni sporitelna. Even the target amount of Kč 240,000, which is eligible for the highest state bonus, is barely adequate for half of a very small new apartment in Prague (Kč 0.6 million at current market prices), although prices in smaller cities are lower. Moreover, in five years, inflation will have eroded much of the target amount value. The amounts will remain sufficient for smaller tasks, such as additions and remodeling.

Finally, building savings loans are not mortgage loans; they are not designed to finance a whole house. According to the German model, they can be used as second mortgages in a "mortgage package" to finance new housing. "A first mortgage covers the difference between the unit purchase price and the contract (target) sum."[2]

Building savings have short-run advantages and long-run disadvantages. In the short run, budget expenditures (Kč 0.8 billion for 1995) stimulate savings, which is more efficient than subsidizing credit. Building savings are a distinct segment of financial markets, so creating them is incompatible with integrating financial markets in the long run. Thus, the government must be prepared to reduce or even eliminate subsidies as the market matures to avoid drawing funds from more beneficial uses. In the medium run, subsidies should be targeted, as they are in Gernany, instead of general.

Because building savings divert deposits from other parts of the financial market that could have financed housing, it is not clear how much additional housing they will stimulate. Other research indicates, however, that building savings can increase the domestic savings rate. Most importantly, building savings provide the right incentive to the public, as they stress individual responsibility in the financing of housing.

MORTGAGES AND MORTGAGE-BACKED BONDS

Laws

Forty-one percent of the Czech housing stock that is disproportionately in the countryside and consists largely of single-family houses has always been private and has changed hands infrequently. Another 22% of the housing stock consists of cooperative apartments, which may be transferred to the tenants if they request it and repay the state loan. Such privately owned units could become the basis of a housing market. About 4% of housing still belongs to the state. The state restituted about 10% to previous owners and transferred the remainder, about 23%, to municipalities. Municipalities have been selling whole buildings to the tenants but now may sell units according to the new condominium law (72/1994). All apartments with sitting tenants are subject to rent control.

The mortgage market in the Czech Republic is emerging only now because the long-term credit market is still developing, because consumer demand has been limited and because until recently the laws failed to provide the preconditions for safe mortgage loans and safe mortgage-backed bonds. Before the recent amendments were adopted, the banking law (21/1992) mentioned mortgages (i.e., liens) only once, and then tangentially, in reference to employee loans. The law did not mention mortgage loans. Thus, all banks could provide loans with a lien on the property, and many banks used this security when extending commercial loans. Secured loans, however, are not mortgage loans.

The emergence of a mortgage market was hampered by a basic disagreement between the government and the Central Bank about mortgage banking. The Czech Republic has adopted universal banking, which the government views as a system in which banks have broadly diversified portfolios. Thus, the government believes that all banks should be allowed to extend mortgage credit. The Central Bank wanted to follow the German model, in part because the model resembles the mortgage system in prewar Czechoslovakia. Instead of amending the banking law to allow for universal mortgage banking, as the government wished, the Central Bank intended to separate mortgage banking from commercial banking.

The German mortgage system relies on issues of "mortgage-backed bonds (MBBs)" for its supply of long-term funds. According to Diamond and Lea, these bonds differ from general mortgage-backed securities because: (1) they are backed by only low loan-to-value mortgages and thus need no insurance; (2) they represent obligations of the issuing bank and are carried on its balance sheet along with the originated mortgages; (3) they are backed by the whole mortgage portfolio, not just a special pool; and (4) as obligations of the issuing bank, they are accorded only 20% capital risk weight.

The Czech Central Bank insisted that only mortgage banks with a highly limited portfolio be allowed to issue MBBs because it wishes to create a safe secondary mortgage market. The German mortgage system is well known for its safety, as no MBB has ever defaulted. The system is based on the issue of up to 10-year bonds which are used to fund up to 30-year mortgages whose contract rate is adjusted when the bonds mature. The system thus precludes any interest-rate risk.

Who buys the bonds? In Germany the MBBs are bought by pension funds and insurance companies. Since insurance companies already exist in the Czech Republic and pension funds were introduced in 1994, the Czech Central Bank assumes that the same kind of secondary market will develop there. Some have recommended that the state purchase MBBs. One reason why the growth of building savings decelerated in 1994 is that people have started to make contributions into voluntary pension plans instead.

The banking law is one of three laws that the Czech Central Bank concurrently considered, all three of which must be mutually consistent. Because the other two laws, which deal with securities and investment companies, are so complex, work on them was slow and inadvertently blocked progress on mortgages. Thus, on November 28, 1994, the ministers recommended immediate action in drafting amendments to five laws to create preconditions for mortgage banking. Parliament passed them on April 18, and they went into effect on July 1, 1995.

The key amendment (84/1995, referred to as "the mortgage law") is to the security law (530/1990), which allows banks to issue MBBs. Because the wording of the original law was too general and other preconditions were missing, no MBBs have been issued. The amendment clarifies two articles that describe MBBs and the rules for issuing them. Only banks that are licensed for mortgage activity can make mortgage loans and issue MBBs. They must keep separate books for MBBs and be subject to extra supervision. The amendment defines mortgage loans in relatively standard terms as credit used to purchase or rebuild real estate in the Czech Republic, whose repayment is backed by a lien against the property. When banks issue MBBs, the property backing them cannot be subject to another lien.

Both the government and Parliament wanted the mortgage law bill to stimulate construction because the Czech Republic has been experiencing feeble housing starts. With this in mind, Parliament made two major changes to the bill. First, as in Germany, the bill had proposed that mortgage loan amounts equal no more than 60% of the value of the property they finance. Parliament, fearing that citizens did not have enough equity, increased the percentage to 70%. Second, the bill proposed that mortgages must be backed by existing construction and thus could not be used directly to start a construction project. Some legislators, however, objected and even suggested that unbuilt houses be used as security for the mortgage loan because banks have been unwilling to offer unsecured construction credit. Government and Parliament reached a compromise. According to a Supreme Court decision from April 25, 1994, unfinished houses for which the first story was completed may serve as security for the loan and MBBs.

The other four amendments removed obstacles to the safety of MBBs. The amendment to the commercial code removed two articles that incorrectly described the connections between the holder of the MBB and the mortgage borrower, and between the holder and the property. The holder has a claim only on the issuing bank, not on the borrower or his property. The amendment to the bankruptcy law specifies that if the bank issuing MBBs is insolvent, holders of MBBs have first claim on the assets, and the bank must still pay interest on the MBBs. The amendment to the judicial code protects the mortgage lender, should the borrower, whose loan was funded by MBBs, default. The bank has first claim on the property, preceding even the right of the state to collect taxes.

The amendment to the banking law states that only banks which meet conditions like separating mortgage activity from other activities will be allowed to issue MBBs. While supporters of universal mortgage banking won in theory, the Central Bank won in practice. Banks must separate mortgage banking due to the creation of a German-style secondary mortgage market and will create separate subsidiaries to conduct their mortgage banking. The concern over who may issue MBBs may be overstated because capital requirements for mortgage banks are no different from other banks.

Bank and Credit Developments

By the end of 1995 there were 59 banks in the Czech Republic, including building savings banks and branches of foreign banks. After the collapse of three banks in the spring of 1994, the Central Bank has been afraid that creating too many new banks would leave some of them undercapitalized. (Two of the largest 10 banks, but of medium size in terms of assets, Banka Bohemia and AB Banka, failed after a smaller bank, Kreditní průmyslová banka, had failed. Banka Bohemia is being liquidated, while the other two are being restructured.) Thus, it has not lifted the moratorium on new bank licenses. The Bank prefers equity participation by large banks in smaller existing banks that would specialize in mortgage loans. Banks wishing to issue MBBs must invest in an existing institution; foreign banks need Central Bank approval to do so. The Central Bank expects no more than 10 mortgage banks to arise.

The Investment and Postal Bank, for example, was a majority holder in Regiobanka Hradec Kralove. In December 1994 it renamed Regiobanka as Českomoravská hypoteční banka (Czechomoravian Mortgage Bank) and increased owners' equity by 50%. The bank thus became the first mortgage bank since 1948 and marks the reemergence of the mortgage market in the Czech Republic.

The Czech Savings Bank is one institution from the prior regime that has done well, because of inertia on the part of the consumers. On December 14, 1994, it began offering 20-year mortgage-like loans, charging 9.75%. On January 1, 1995, both the Commercial Bank and the Czechomoravian Mortgage Bank followed suit, the latter offering up to 30-year loans at 10%–11%. The Commercial Bank created the Mortgage Institute of the Commercial Bank and offered up to 20-year mortgage-like credit at 10.5%. It separates residential and commercial mortgages to keep state support of residential mortgages transparent. Commercial mortgages are offered by Commercial Bank directly.

According to the mortgage law, banks need a special Central Bank license to issue mortgage-backed bonds, and each issue must be approved by the Finance Ministry. The Central Bank issued the first license to Czechomoravian Mortgage Bank (CMHB) in September 1995. At the same time, it approved the application of the local branch of Bayerische Vereinsbank to become an independent bank, Vereinsbank (CZ), specializing in mortgages as of January 1, 1996. Czech Savings Bank (CS) and the Mortgage Institute of the Commercial Bank (HUKB) received their licenses in October, and at least three other institutions are expected to apply.

In 1995 none of these institutions issued any MBBs, because they needed mortgages to generate the cash flow to pay interest on the MBBs. In May CMHB announced that its first issue of MBBs would have face value of Kč 1 billion, maturity of five years and a smallest denomination of Kč 10,000, an amount affordable to many households. Since loans can be made up to 70% of the initial property value, Kč 1.43 billion-worth of property is needed to back the first MBB issue in the volume of Kč 1 million. In September 1995, when the CMHB made about one-quarter of the necessary mortgages, MBBs were expected to cost over 9.15%, which was the rate on government securities.

The mortgage law specifies that 90% of the nominal value of the MBB must be backed by mortgaged property, with the remaining 10% being backed by cash and government securities. Thus, banks will not permit mortgage prepayments because MBBs would be insufficiently covered if the loans were no longer in the banks' portfolio. Should borrowers prepay early, their penalty may equal the foregone interest so that the bank does not face any interest-rate risk. Borrowers, however, will be allowed to prepay as the MBB comes due.

Other real estate loan techniques. Because the funding portion of the mortgage credit system has not been completed, real estate loans extended so far have been financed through deposits and are referred to in print as "premortgage" loans. CS has been offering premortgage loans through 1995. Borrowers obtained 659 loans totaling Kč 422 million, for an average loan of Kč 0.64 million. In December 1995 CS began to accept mortgage applications for existing houses, renovation and repayment of earlier loans backed by real estate. CS charges rates starting at 10.5% and guarantees them for one year. It hopes to lower its cost of funds when it issues MBBs, mainly to institutional investors. It plans to reduce the mortgage rate accordingly and to guarantee it for three to five years. The maturity of loans for residential construction is 20 years, but that of loans for nonresidential construction is only 10 years. CS has no minimum mortgage amount. Since the maximum loan-to-value ratio is 70%, CS offers supplemental credit up to a 90% loan-to-value ratio at 12.5%.

CS also introduced construction credit for up to 85% of the value of the construction at 11.75% interest. A firm receives credit only after the construction project is entered in the cadaster (real estate register). Many builders are thus wary, because registering a project may take up to three months. They cannot apply for registration until the project is effectively completed, and then their funds are locked up until registration arrives. While registration took an average of 55 days in the first half of 1995, it can take up to nine months in some cities. Firms need only repay the interest on construction credit, which is disbursed as construction proceeds. The principal is repaid with mortgage credit upon final approval of the project. The rate on all three credits—mortgage, supplemental and construction—can be 1%–1.25% higher for riskier clients or projects.

By December 8, 1995, CMHB had extended 160 loans totaling Kč 155 million at 11.3%. CMHB has noted a marked increase in mortgage applications, up to 10 daily. More than half the applicants have sought mortgages for detached homes; the rest want loans for apartments and business residences. Half the applicants want to buy the property, while the rest want to construct a new property or to renovate. After the signing of the subsidy agreement, the bank plans to lower interest rates to 10.4% to compete with CS, but only the best customers—those with income two to three times the necessary minimum income—will be eligible for this rate.[3] CMHB requires at least 1.6 times the poverty line to remain after the mortgage payment is made. About a third of the loans extended since July 1, 1995, are eligible for state subsidies. CMHB has products similar to those of CS and requires both life insurance and homeowner insurance for its loans. So far only CMHB gives credit for new construction.

HUKB remains a distant third behind CS and CMHB, both of which have traditionally close ties to savers. By the end of September, HUKB had issued only 14 premortgage loans, totaling Kč 62 million. HUKB is more conservative in granting mortgages; it does not make loans until the project has a roof. Vereinsbank plans to offer mortgages in January, starting at 11.25%.

Borrowers can usefully combine mortgages and building savings. While the Czech Republic has been slow to enact mortgage legislation and mortgage subsidy, its timing has been fortunate vis-a-vis building savings, coming roughly two years after its initiation, just when the fastest savers become eligible for credit. Those who have saved the requisite amount may now use it for mortgage downpayment and combine their building credit and a mortgage loan of up to 70% of the value of the property. For example, a Kč 300,000 downpayment on a Kč 1 million property can be followed by a Kč 300,000 building savings loan and a Kč 400,000 mortgage loan. Such a combination increases the number of potential borrowers because it is cheaper than mortgage credit alone. CMHB offers such a combination with the cooperation of Českomoravská stavební spořitelna. Both are part of the IPB banking group. CMHB mortgages start at Kč 400,000—Kč 200,000 for reconstruction in order not to compete with the building saving loans of the other subsidiary.

OTHER SUPPORTING LEGISLATION

The current system of foreclosing on mortgaged property is too cumbersome, as it requires a court hearing. The Ministry of Economy drafted and presented to Parliament a public auction law to allow mortgaged property to be auctioned off without a hearing if the debtor does not meet the contract terms. The government claims that a quick public auction can be advantageous even for creditors because it can yield a higher price.

Auctioning property in the Czech Republic is further complicated by the protection the civil code offers tenants. If a bank auctions off a house, it does so with the current tenant in residence, unless he voluntarily moves. Until the November 1994 amendment of the civil code, the buyer had to find substitute housing for a nonpaying tenant before he could move in; now he may offer only "shelter." While repossession is infrequent in the mortgage market, the presence of tenants increases the risk of mortgage contracts.

Another reason why the Czech Republic was slow to introduce loans was the lack of explicit customer demand. The relative price of houses is very high, and most Czechs cannot afford unregulated housing. A typical small new apartment costs about 0.6 million Kč, roughly nine times the annual salary of 76,656 Kč. A small house, which may be purchased for about 1.5 million Kč, costs about 11 times the annual household income of 132,000 Kč (1994 figures). Thus, the government became convinced that it must subsidize mortgages if they are to be more than hypothetical instruments. According to initial government estimates, only 5% of the population could afford a Kč 1 million loan—enough to buy a comfortable apartment—at 10% interest. On December 8, 1994, as a first step, Parliament amended the tax law to exempt MBB earnings from taxation.

As early as 1994 the government considered a 3% direct subsidy to mortgage interest payments. ODA, a major opposition party that favors a freer housing market, said it would continue to lobby for the tax deductibility of mortgage interest. The government chose subsidies for their transparency and to prevent skyrocketing entitlements. It has warned that mortgage support may decline after the year 2000. In March 1995 the Ministry of Economy further proposed that only mortgages for new construction would be subsidized. In the summer of 1995 this proposal was formalized, and on September 11, the government approved an edict, which went into effect on October 26.

The edict specifies that private individuals are entitled to a subsidy for mortgages of less than 20-year duration used for land and residential construction, or the repayment of credit received after January 1, 1995, for prospective residential construction. Firms are not entitled to subsidies but are eligible for support. Funds become available to support firms only if private individuals do not exhaust the funds allocated by the state for subsidies. Once granted, however, support continues for the duration of the mortgage. Both support and entitlement subsidies lower contractual mortgage interest payments by 4% for one year after this edict becomes effective and by 3% thereafter. These figures are guaranteed for five years after the edict takes effect. Support and subsidies are limited to the first Kč 1.5 million of a mortgage for a detached house, the first Kč 2 million for a duplex and the first Kč 12,000 for 1m² of the purchase price of the property.

The government had allocated Kč 200 million, or about .05% of its 1995 budget, for mortgage subsidies. The F& E Ministries delayed signing a formal agreement with mortgage-granting institutions because the details of how the FM would provide the subsidy to the institutions had not been worked out. As a result, no funds were released. The agreement with Czech Savings Bank and with Czechomoravian Mortgage Bank was finally signed on December 22, 1995, and the same agreement with Vereinsbank and Commercial Bank was signed in January 1996. The total subsidy increases to Kč 500 million in the 1996 budget, and the government proposes increases by this amount for the next five years, an amount it estimates to be sufficient for eligible non-business borrowers. The edict contains no criteria as to who is eligible for support. In response, banks have proposed giving support based on the date of application. ODA, however, is concerned that banks are open to bribes from businesses due to the excess demand for support intrinsic to the program.

Some authors have warned that introducing mortgage finance into a regulated housing market may do more harm than good because it further increases housing prices. Price increases result from the slow response of the flow supply of housing to any policy. The unresponsiveness comes from two sources. First, as is generally recognized, the short-run supply of housing is very price inelastic. Moreover, regulation permits only a small portion of the total stock of housing to respond to market forces. The govenment must therefore shift out the supply curve for housing in the long run. The quantity of housing thus depends on urban and regional planning, which have also stagnated and must be reorganized with the same care that has been lavished on the resuscitation of the mortgage market.

CONCLUSION

The mortgage market in the Czech Republic is a developing market within a transitional economy. An efficient mortgage market is vital for the private housing sector because it translates the need for housing into housing demand. The government chose to develop the mortgage market along the lines of the German and French systems in a way that is consistent with its own precommunist past. The amendments enacted last year increase the safety of both mortgages and mortgage-backed bonds and complete the legal structure for mortgage markets. The pace at which the Czech mortgage market will develop is tied to the development of the long-term credit market, the disparity between housing prices and real wages, and the strength of tenants' rights.

REFERENCES

Čechlovský, Vladimír, "CS poskytne hypoteční úvěr až po dokončení stavby," *Právo*, Decem-ber 12, 1995.

Diamond, Douglas B., Jr., and Lea, Michael J., "Housing Finance in Developed Countries," *Journal of Housing Research*, 1992, Vol. 3, No. 1.

Doucha, Rudolf, "Co uvážit, aby stavební spoření dobře sloužilo," *Hospodářské noviny*, October 19, 1994, p. 11.

"Hypotéky budou oba konkurenti nabízet za stejných podmínek," *Mladá Fronta Dnes*, December 30, 1995.

Jašminský, Martin, "Stavební spořitelny usilují o klienty," *Svobodné slovo*, November 18, 1994.

Káňová, Klára, "Pojistky zdraží hypoteční úvěr," *Profit*, No. 19, 1995.

Krčová, Bohumila, "Smržovka si troufá," *Ekonom*, vol. XXXVIII, No. 39, September 29, 1994, pp. 45-46.

Lea, Michael J. and Renaud, Bertrand, "Contract Savings for Housing: Suitability to TSE Financial Reforms," paper presented for American Real Estate and Urban Economics Association at the ASSA meetings, Washington, D.C., January 1995, 57 pp.

Ministerstvo hospodářství et al., "Návrh programu spoluúčasti státu na podpoře bytové výstavby a bydlení," materiál pro poradu ministrů, November 3, 1994.

"Nařízení vlády," *Hospodařské noviny*, October 24, 1995, p. 24.

"Otázky státní podpory," *Svobodné slovo*, November 19, 1994.

Polívka, Milan, "Dohnat a předehnat," *Ekonom*, vol. XXXVIII, No. 47, November 24, 1994, pp. 26-27.

"Prudký nárust žádosti o hypoteční úvěry," *Telegraf*, December 13, 1995.

Půlplán, Karel, *Nástin českých a československých dějin do roku 1990*, Univerzita Karlova, Praha, 1993.

"Regiobanka se přejmenovala na Českomoravskou hypoteční banku," *Mladá Fronta Dnes*, December 21, 1994.

Ubiria, M. V. Kadlec and Matas, J., *Peněžní a úvěrová soustava Československa za kapitalismu*, Státní nakladatelství politické literatury, Prague, 1958.

Vencovský, František, "Hypotekární úvěry nemohou zůstatbílým mistem," *Bankovnictví*, No. 22.

"Zájem o meziúvěry," *Profit*, No. 43, 1995, p. 4.

ACKNOWLEDGMENTS

I thank Michael Leeds, Michael Lea and Bertrand Renaud for their helpful comments and to Martin Mandel, Vit Štěpánek, František Vencovský, Jan Wagner and Petr Zahradník for providing background information. My stay at the Ministry was partly funded by the Foundation for a Civil Society.

NOTES

[1] Lea and Renaud 1995, pp. 35-36.

[2] Lea and Renaud, p. 23.

[3] Currently, rates on medium-term government securities are 9.5%, high-quality mortgages are 10.5%, construction loans are 11.5% and supplementary loans are approximately 12.5%.