POLAND

Developing Mortgage Finance in Poland's Transforming Economy

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POLAND'S TRANSFORMING ECONOMY

Poland is a Central European country with almost 40 million inhabitants. Before the Second World War the country had a market driven economy, with mortgage banks issuing mortgage bonds in dollars and major European currencies. For 50 years (1939–89) the market system and democracy did not exist, because of the war and the Soviet-type non-market economic system imposed after the war.

In June 1989 the first semi-democratic elections took place leading to the formation of the first democratic government, which undertook the bold mission of creating—or reviving—a market economic system in the country. At the onset of the transformation in 1990, a radical legislative package establishing the basic institutions of a market economic system was introduced. During the first half of the 1990s, the initial years of fundamental and radical transformation were followed by a successively slower pace of change forced by the increasingly complex socio-political circumstances of a maturing new market system. The transformation process has been characterized by a stabilization of the economy and money supply, small privatization (mostly service companies and firms), emergence of a rudimentary capital market, establishment of positive real interest rates, and the creation of and initial development of real estate markets. At the same time it has been a period of declining, albeit still too high, inflation, and a period of falling production and declining real incomes. Subsidies have been gradually withdrawn from the housing market causing restructuring and reallocation pressures.

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The bottom was reached and recovery began sometime in 1993, when the economy exhibited incipient growth driven by the dynamic fledgling private sector. A process of sustainable growth has held to the present with Poland registering 7% economic growth rate in 1995—the highest in Europe—and is projected to continue at a pace of 5%–6% growth for the rest of the 1990s. The majority of the labor force is currently employed in the private sector, which is responsible for about one-half of the national income. Poland's economy today is the second largest in the post-Soviet world (after the Russian Federation). Gross National Product per capita is about $3,000 and average monthly household income stands at some $400. The capital market has been developing dynamically with the Warsaw Stock Exchange attracting increasing numbers of foreign investors.

The country has achieved a remarkable degree of transformation towards market economy. Despite the apparent successes there remain serious challenges. Inflation has been going down, but still stands at some 20% per annum. Unemployment has ceased to increase but still stands at 15%. The banking sector, although partly privatized, is still not very efficient as it is saddled with bad debts from the previous economic system and lacks access to almost nonexistent long-term savings. The budget deficit has been kept at approximately 3% of GDP, but government debt has been increasing very quickly. Thirty percent of the population of the country is still in agriculture, and heavy industry has chronic overemployment. The long-term saving propensity is too low for an economy with acute need for restructuring and investment. One of the big problems has been plummeting production of housing and the deteriorating condition of the existing stock. The development of two sectors indispensable for housing, real estate and mortgage markets, has not occurred to a significant degree.

EMERGING LAND AND REAL ESTATE MARKETS

The role of real estate resources in the transforming Polish economy is very important in dealing with the profound misallocation of resources which took place during the Soviet era. Too many land resources were allocated to industrial and agricultural uses and too few to residential and commercial ones. Lacking real price signals and economic incentives to recycle land sites over time, the administrativecommand system created startling patterns of land use with a perverse population density gradient; rising as one moves away from the center of the city, in stark contrast with market driven city structures. Equally remarkable, the location of industrial jobs remained highly centralized, leaving today a significant number of inefficient factories in prime locations. Such an urban structure tends to maximize the internal inefficiency of a city in terms of energy use, infrastructure and commuting requirements with staggering environmental costs.[1]

The development of efficient urban land markets is the only way to remedy the costly distortions and inefficiencies through a decentralized, incremental and organic process in Polish cities. Mindful of that, the government started early with legislative actions to create, or revive, real estate markets in 1990. Most real estate in the previous economic system was occupied and used by state-owned enterprises and other non-private entities such as cooperatives. Creation of a market mechanism required reviewing and addressing the questions related to basic requirements for market existence: definition and protection of property rights, vesting of these rights in physical units, developing mechanisms for transferring property rights, safe registration of these rights, financing mechanisms, a regulatory land use framework, access to reliable information, existence of professional services and other elements of orderly real estate markets.[2]

But there are still many impediments to the development of satisfactory land and real estate markets in Poland. These include the lack of comprehensive and reliable information about vacant building lots and market prices, unclear ownership status, and unclear zoning and building requirements. The many real estate brokerage firms, all of them private, provide only partial information about the supply of land and no institution offers a full data base on land market activity. The ownership title registration system, the so-called perpetual books, do not cover all of the land with cleared titles, being backlogged with an overwhelming amount of work. Much of the attractive developable residentially zoned land is kept by housing cooperatives, which were granted perpetual leasehold rights to these lands in 1988. Most of these cooperatives bank this land and, in the absence of market value based property taxation, can afford to withhold the land from the market with negligible carrying cost. Greenfield lands on peripheries lack infrastructure that small developers cannot afford to provide themselves. Land is usually classified as agricultural and procedures for changing the permitted land use are cumbersome and protracted.

EMERGING REVOLUTION IN HOUSING FINANCE

The Legacy of the Soviet Era

Housing in Poland during the Soviet era was characterized by several fundamental principles:

- Housing was defined as a social merit good, distributed through administrative decisions for a symbolic price;
- Decisions regarding housing production, its standard, location, etc., were subject to the political process at the central level and not to local demand conditions;
- Housing policy constituted an integral part of employment policy in regards to spatial distribution and allocation.

Until the mid-1950s, the dominant housing production model was the state/municipal provision of rental housing. Later periods were characterized by a mixed model of state/municipal, enterprise, cooperative and private (mostly single-family) residential dwelling types. A peculiar feature of the Polish housing sector was the relatively large share of private dwellings, which existed mainly in agricultural areas and in smaller towns.

Financing of the housing sector was done with a high degree of state subsidization, but the extent and forms varied with ownership categories. Municipal, enterprise and private rents were centrally set and regulated, and the level of these payments covered a mere 30% of operating and maintenance costs. Only part of the shortfall was made up by central budget subsidies, so the physical condition of the stock successively deteriorated through deferred maintenance (so-called "decapitalization"). Household effort ratios, expressed as a share of housing costs in household incomes, were very low. Rent payments constituted typically 2%–3% of household income, and together with utility bills they constituted a 5% to 9% effort ratio. By 1995, due to continued rent controls, the effort ratio for rents was only 4% of household income, but steeply rising de-subsidization of utility costs (especially energy) made total housing expenses rise to some 14%–16% of household incomes. In the cooperative housing sector "monthly payments" were much closer to operating and maintenance costs, and most of the subsidization took place in the form of heat and hot water provision. Their effort ratios (25%–40%) have been much higher than in the public rental sector.

Housing construction was highly subsidized as well. Municipal housing construction was financed entirely with budget subsidies, while enterprise housing construction was financed partly through increased production costs of the enterprises and partly through low-interest state loans. Cooperative housing construction was financed partly with the resources of cooperative members, which covered some 10%–20% of the costs, partly with state grant subsidies (20%–50%) and partly with low fixed-interest state loans in a 20%–30% inflationary environment. Servicing of land (infrastructure) was financed, or refinanced (cost refunded) from central budget sources. Land for development of these housing categories was transferred for free after expropriating it from owners (if any existed). Repayment of the low-interest housing construction loans was stretched over 50 to 60 years. Consequently, equity contributions of households in the financing of housing construction of this type did not exceed the 2%–4% of costs. Private construction was also partly financed with subsidized credits, and although these were limited, they still accounted for a 40% share in financing costs.

Cooperative Members Without Choice

Funds for housing credits were mobilized through deposits of the household sector. The credits carried a negative real interest rate, and the difference between the 2%–3% lending rates and the 10%–20% deposit rates was covered with central budget funds. Systems for construction, financing and management of the housing stock were closely related to the concept of centralized management of the economy. The construction sector was dominated by huge building factories (with several thousand employees) called "kombinaty," which used large scale concrete panel technology. These state companies collaborated mostly with housing cooperatives, which acted as de facto property investors, developers and managers. The cooperatives had between several to tens of thousands of members who had no choice of selecting other development or management companies.

Construction was financed by a state savings monobank (PKO) through its local branches. It automatically granted loans to housing cooperatives, and serviced their financial arrangements in regards to central budget subsidies. The cooperatives serviced the internal financial relations with individual households. In summary, housing investments were funded less than 20% by equity contributions of beneficiary household users. The rest of the funds came from direct and indirect central budget subsidies and transfers. The system was hailed as socially right by declaring that each household could count on obtaining a dwelling. In reality, most of dwelling allocation was linked to employment policy run by political and economic policy considerations, and serious shortages arose despite high construction volume.[3] One of the reasons was in the cooperative sector, where dwelling allocations were guided mostly by household size and not by income. The consequences of the artificially low dwelling prices were very long waiting lists (1.7 million places), and dwelling swaps of dubious legality. The misallocation was exacerbated by the strong growth of households (a result of the postwar baby boom) in the late 1970s and early 1980s, and the high rate of migration from rural to urban areas, stimulated by the policy of extensive industrialization.

The Shock of Variable Market Interest Rates

At the time the transformation process began, there existed no systematic transformation program for the housing sector, which was exposed to the forces of the macroeconomic stabilization package of the 1990s. The pressures for change were substantially resisted by the cooperative lobby and various social movements rooted in the previous system. Policy decisions were lagged and minimized suggesting that the housing sector was acting, even if unconsciously, as a safety valve for containing social dissatisfaction with other consequences of the transformation process.

The most radical reforms affecting the housing finance system were connected with immediate imposition of positive real interest rates in the banking system with the concurrent switch to variable rates. Less immediate, but still radical in scope, was the strong successive reduction of budgetary subsidies which, together with high and variable nominal interest rates, led to a dramatic increase of construction costs in 1991.

During the shock period, which stretched between 1990 and early 1992, most of the interest was focused on the dramatic contraction of construction activity, which was to be contained through new financing solutions (mortgage credit, payment indexation) and temporary easing up of regulations concerning building permits and approvals. In the ideological sphere, a liberal orientation was dominant. During that period, quick privatization was often declared as an indispensable element of a market-oriented housing sector. There followed intensive discussions about the need for condominium legislation, deregulation of rents, and introduction of a wide-spread mortgage credit system. In practice, much of the effort was focused on rationalizing the housing loans legacy and on starting up a new housing finance system based on mortgage credit. Efforts to deregulate rents and accelerate housing privatization were met by stubborn opposition in the Parliament. Extensively modified legislative proposals were adopted only in 1995. To some extent it was possible to rationalize the problem of old loans (although the issue dragged on until 1995) and through this consolidate the background for development of a mortgage credit system, which was initiated in limited form already in 1992.

The interest rate shock, in terms of dramatic increase in the level and variability of rates, stopped the demand for new loans but created a protracted problem with loans in early disbursement or repayment phases,[4] as well as those which were closed but not commenced. The problem of these "old" housing loans refers to those in which housing construction commenced during the years 1990–95. Other loans, started earlier and carried by several million cooperative dwellings did not constitute a problem, since their outstanding balances were quickly depreciated by hyperinflation and most were quickly paid off in fear and amid rumors about the possible conversion of existing loans to variable, inflation-related interest rates and valorization (indexation) of debt amounts.

The problem of "old loans" was addressed by indexation mechanisms with mixed success. Until 1990, cooperative construction together with associated commercial space was financed with low-interest loans from the PKO state savings bank, which was at that time simply a department of the Central Bank. The difference between interest rates paid on household savings and lending rates on housing credits was subsidized by the central budget. During loan disbursement, interest was deferred (capitalized) into the loan amount. At completion the central budget refunded infrastructure costs. Some 20%–50% of the outstanding balance was forgiven, and about 10%–20% of the amount was collected from cooperative members taking possession of their flats (equity contributions). The remaining outstanding debt was automatically converted into a long-term loan (40–60 years) to the cooperative (repayment phase) and apportioned internally by the cooperative to its members according to their dwelling areas.

The introduction of variable nominal interest rates created the classic real payment tilt problem for borrowers unable to pay full interest during the early years of the loan. Equally classic was the reaction of the government, which responded by introducing interest rate subsidies in 1991 which, in the highly inflationary environment led to budgetary problems. Thus, in 1992, a new repayment system for these loans, based on payment indexation, was introduced with an initial payment amount related to average dwelling size and calibrated to 25% of household income (at loan commencement) and 15–20 year amortization period. Changes in payments were indexed to movement in individual household incomes. This way a quasi Dual Index Mortgage mechanism was imposed on the existing loans with the exception that loan amounts on the already closed contracts could not be changed and correlated to affordable levels.

The introduction of indexation together with interest deferral and its capitalization gave rise to liquidity problems for the PKO bank. In 1989/90, just prior to the transformation, it signed many loan agreements with cooperatives, which forced the bank to continue financing many projects well into 1991 and 1992. In order to maintain the liquidity of the bank, a "temporary purchase" of capitalized interest by the central budget was introduced on the condition that the bank (through its borrowers) would start repaying this "liquidity financing" after construction was completed and repayments commenced by the borrowing cooperatives. The system functioned until the end of 1994, and by 1995 practically all of the cooperative dwellings financed with the "old loans" were completed. The regulation discontinued the alignment of payment changes to movements in individual household incomes and introduced a broad index based on movement in average wages in the economy as applied to average dwelling size. At the same time that the old loans were being restructured, new DIM loans were introduced in mid-1992 with loan amounts based on actual household incomes and payments indexed to changes in average wages. For the next two years the two systems (for old and new loans) were running in parallel. In 1995 the two systems were collapsed into one (using average wages as the index).

Due to political pressures, the formula for initial payment size was made more permissive in that the initial payment on a new loan for an average dwelling (60 m2) was set at an effort ratio of 15% (previously 25%) of household income. At such a ratio there is a higher risk that a significant portion of these credits will not be fully repaid by borrowers, and the central budget will have to cover the losses. At the same time, the central budget continues to automatically exercise the "temporary purchase" of deferred capitalized interest from the PKO, even though the bank is enjoying good liquidity. Recently, the left-leaning government has decided to write off its claims to collect the accrued capitalized interest on these loans. This has realized the hopes of many borrowers for receiving an ex post interest rate subsidy.

The Dual Index Mortgage

The dual-index mortgage eliminates the "tilt" problem inherent in loans with fixed nominal payments in which early payments must have higher real values to compensate for the erosion in the real value of later payments. The DIM works by adding to principal any difference in the payment accruing based on a variable market interest rate (e.g., the average cost of funds of a bank) and a lower payment due initially set at an arbitrary rate (e.g., a percent of the borrower's income or initial loan balance) and adjusted thereafter according to changes in a measure of income (e.g., a wage index). In its pure form it is a loan that can be both profitable to the lender (at either a fixed or floating real rate, depending on the source of funds) and affordable to the borrower. The principal issues raised by the DIM are the funding of the deferred interest (negative amortization) which can create liquidity problems for lenders and the need for a reliable income measure (to ensure that the loan will pay off if real incomes rise).

Impact on Construction

While housing construction based on old loans continued during the early years of the transformation, new construction quickly plummeted as potential borrowers discovered the unaffordability of new housing, given the high unsubsidized construction costs, high nominal interest rates and low household incomes. A significant response took place in investor categories with a sharp reduction of cooperatives, the virtual disappearance of enterprise housing construction, a minimal share of public housing investors (municipalities), and a rising percentage share of private investors.

Some cooperatives began to build housing for market or on a prepayment basis for non-member potential buyers. Smaller cooperatives began to act as developers for their own members by subcontracting professional firms to act as investors on behalf of the cooperative members who, after completion, take over the assets in individual ownership and liquidate the cooperative structure. There are also instances where development companies organized future buyers into a cooperative and supplied them with building and developer services. The popularity of using the cooperative development structure, as compared to typical developer model, stems from tax advantages (lower notarial fees and stamp duties) and easier access to public land (exemption from the competitive bidding requirement). An additional attractive factor is a more favorable attitude of officials of various administrative bodies towards cooperatives.

A characteristic feature of housing construction activity in Poland during the first half of the 1990s has been the cash-driven construction process with a small share of credit capital. Many good entrepreneurs and capital groups left the building investment sector for more promising sectors offering a faster return of capital. Consequently, small developers are usually undercapitalized and are unable to finance much investment. Construction loans are mostly unavailable due to aversion of the banks to engage in that sector in a high inflation environment and the lack of a track record of new small firms.

INSTITUTION-BUILDING FOR THE MORTGAGE MARKET

The tedious job of developing an orderly housing finance system based on mortgage credit began seriously after the initial radical macroeconomic shocks. The efforts to address various aspects of mortgage credit development included the mobilization of long-term capital, design of lending instruments and education of borrowers. In addition, the general housing environment was to be reformed with the goal of developing more efficient real estate markets.

While mobilization of long-term capital was left to the development of capital markets and promotion of savings habits through positive real interest rates on deposits, most of the government effort in mortgage finance reforms was devoted to instrument design. The issue was developing an instrument suited for the conditions of macroeconomic instability and a high inflation scenario. New mortgage-secured loans were offered for investments in housing construction. They were essentially based on a Dual Index Mortgage philosophy proposed by the World Bank team working with the central government and participating banks. This introduced a number of spin-off institutional effects into housing finance institutions such as the state savings bank (PKO) and the cooperative state savings bank (BG), who are by far the largest lenders in housing. A break-up of "block" loans into construction loans and long-term investment credits linked only through take-out commitments was introduced in 1992. At the same time, the banks discontinued granting housing block loans to cooperatives but started to underwrite mortgage loans to individual household borrowers. DIM mortgages started to be offered in 1992, but the government, which committed to "temporarily purchase" deferred interest, increased maximum loan amounts to unrealistically high multiples of monthly household incomes, thus creating many non-performing loans at the start. The temporary purchase of deferred interest has turned out to be an ex post subsidy most borrowers were counting on.

In 1993 a new entrant into the housing finance system, the market based Polish-American Mortgage Bank, started to offer construction loans and mortgage credits (for new and existing housing) with real interest rates indexed to dollar exchange rate movements against the Polish zloty. In 1994 a DIM system funded partly by the World Bank loan was started through a number of participating Polish banks lending to developers abiding to market-derived requirements for professionalism.[5] The system has been slow to start, as competing with more subsidized products of the PKO bank was impossible. In 1995 the PKO discontinued its highly subsidized products and started to offer more market-based DIM products. In 1996 an additional element of housing finance is to be introduced in the form of a contractual savings system. In 1997 a new law defining mortgage bonds and possibly mortgage banks will probably be passed.[6] At some more distant future it is expected that a secondary mortgage market institution will be created in Poland. However, the process of institution building is very tedious, since many contingent problems are being discovered on the way.

Increasing Product Choice

While the old system was characterized by the existence of a single highly subsidized product, the newly emerging system is offering several alternative financing products to the borrowers.

The PKO state savings bank, which is by far the largest deposit-taking institution, started to offer two new DIM-type products in 1995. Both use the weighted average cost of deposits as the interest rate index. The primary difference between the two products is the method used for computing the monthly payments over the life of the mortgage. One product is referred to as the "normative" mortgage and differs from the standard DIM mortgage in the wage indexes used and the formula applied to compute monthly payments.[7] The other mortgage product of the PKO, the "indexed" mortgage, computes the initial payment as a percentage of the borrower's monthly income and increases the payment over time by a percentage of a market interest rate.[8] The "indexed" mortgage requires higher initial payments than the "normative" mortgage, and since the indexed mortgage is not based on increases in wages, the payments required may be higher or lower than the DIM.

The PKO calculates that such loans will have an effective amortization term of 20–25 years. PKO loans may be collateralized with mortgages on subject properties, but the bank accepts other forms of collateral, such as mortgages on other properties, personal guarantees, cession of receivables, etc. The 1995 experience (500 loans in six months) of these new products shows that most clients prefer small loans using the "indexed" model, which shifts repayments to later periods. The clients of the PKO are recruited mostly from cooperative members, who borrow in order to finish their dwellings built with equity contributions.[9]

The Polish-American Mortgage Bank offers mortgage credits with 10-year amortization periods at real interest rates of 12%–14% in an inflationary environment of 25%–30%. The rate is fixed and repayments are indexed to changes in the exchange rate of the dollar. Since the dollar has been appreciating at a slower rate than inflation (and incomes), the real rate on these loans has been around 7%–9%. These credits have been very popular, and the bank has used up most of its resources for loans and is looking for a new source of funds. Presently, most funds have come from the founder's equity. The bank is thinking about issuing mortgage bonds or structuring a private placement of loans with emerging insurance companies or private pension funds. In 1994 it granted 229 mortgage loans totaling almost $10 million.

The lending program based on the World Bank loan began in 1991 with the pioneering philosophy of dual indexation. In 1992 an official loan was signed with the Government of Poland, but actual lending started only in 1994. Despite the small scale (by the end of 1995 some 350 mortgage loans), the external influence of the project has been immense in stimulating the evolution of mortgage finance in the country through inspiration, training and market based lending requirements. Thanks to the assistance of specialists on the project, the PKO bank was able to rationalize its old-loan portfolio, develop new dual-indexation products, revamp mortgage underwriting procedures and require the investors to prepare credible feasibility analyses. The system developed by the World Bank project focuses on universal banks as participating mortgage lenders. The source of funds for participating banks is the BudBank, which resembles an American secondary market institution. The BudBank is a government bank which administers the Mortgage Fund (set up with the money from the World Bank, EBRD, USAID and Poland) by on-lending it to participating banks (80% for construction loans and 90% for permanent loans) and requiring these banks to use the DIM structure. The Fund is essentially providing both long-term money and refinancing of liquidity gaps created by the deferred interest feature of DIM mortgages. It is envisaged that the BudBank will eventually develop into a secondary market institution that will issue MBS instruments and buy up existing standardized mortgages.

Other External Models

Another instrument being introduced in Poland is the contractual savings and loans program patterned after the French open-ended system. The period of contractual saving cannot be shorter than three years with the option of shortening it to two years for those who demonstrate that they use their deposits, including the government bonus, on their housing purchase. Deposits collected on a contract account shall bear interest of not less than 0.25 of the rediscount rate of the National Bank of Poland, with an absolute minimum of 2% annually. The interest on contract credits granted shall not exceed 0.5 of the current prime rate of the NBP, but not less than 4% annually. Following the regular savings period, the depositor has the right to apply for credit as specified by the contract, usually not exceeding 150% of savings. It is assumed that in the initial period of operation, the contract mortgage credit will be first and foremost directed at housing improvements, turnover of existing stock, capital renovations and construction funded by the borrower's resources. To a lesser extent will it be directed towards new construction, which requires a longer savings period. In the future, contract crediting will play a supplementary role to the basic mortgage credit granted by the banks. Lower interest rates will be achieved through:

- interest rate on deposits lower than market rates (the self-help principle),
- interest on savings that is income tax free,
- exemption of the bank from the duty to transfer obligatory reserves on the funds of the housing savings institution to the Central Bank.

Financial balance of the contract system depends primarily on the dynamics of savings growth. To foster increased savings, tax breaks are provided for participants in the contract system during the savings period and savings guarantees are issued by the State Treasury.[10] Assuming an optimistic scenario for reducing inflation in Poland, the fiscal benefits may effectively encourage people to participate in the new savings and loans system. In order to ensure the safety and stability of the system, there is a possibility of liquidity injections from the National Housing Fund. Incomes of the contractual savings institutions (interest, commissions on credits, interest on bank deposit accounts, income on securities, operating fees) less operating costs must be entirely spent on contract credits and maintenance of current financial liquidity.

A high inflation rate as a rule reduces the attractiveness of the contract instrument for the creditor, especially for a multiple as small as 1.5. That is why variable interest is offered, whose aim is to protect savings from excessive erosion through inflation. This, however, requires indexing the contracted credit, which raises the risk of the real growth of debt. Thus, the contract credit is seen as supplementary to the basic mortgage credit, which is also indexed (the DIM). There is no fixed interest rate, which may result in budgeting insecurity for borrowers. However, contract crediting permits borrowers to build positive credit histories for the duration of the savings period and ensures access to credit in the future, which is valuable for borrowers when mortgage security valuation is difficult.

The proposed system may not be able to fully avoid the risk of liquidity imbalances, but this is to a certain extent offset by the low value of the multiplier and the expected increase in contract deposits, as well as the refinancing line in the National Housing Fund. It may also not be the most efficient mechanism for stimulating savings, and it cannot replace the primary mortgage loan.[11]

IMPEDIMENTS AND PROSPECTS

The housing finance system in Poland is beginning, albeit tentatively, to take shape. General positive economic development is generating an increase in long-term savings. This capital should be able to find ways to mortgage credit instruments through formal financial institutions. As long as inflation stays high (currently at 20%) and incomes are low, financing of housing investments will require very high portions of equity capital (currently at 50%–70%). This will foster the continued use of many informal mechanisms, especially in rural areas, and the efficiency of the housing finance system will remain low with many construction projects taking many years to complete.[12]

Depository institutions have been developing DIM-type instruments and using variable rates to control term risks. The deferred-interest system has been supplemented with liquidity lending with foreign funds (World Bank, USAID). Lending institutions may soon be able to issue mortgage bonds and, possibly, mortgage banks may be able to function. Contractual savings programs have been initiated. A secondary mortgage market institution may be built around the World Bank project's on-lending institution (BudBank). It seems that creation of basic institutions for development of the mortgage market will take final shape within several years.

Despite these various reforms and innovations, the share of mortgage credits in financing of the housing sector in Poland is still very small, and not everything may be traced only to the high inflation environment. The social and economic context is not yet favorable to an extensive development of mortgage credit in Poland. The impediments are high inflation, unstable real interest rates and household incomes, slow accumulation of long-term savings, and thereby credit capital, as well as a significant level of political and institutional instability. The interest rate on credits shows the tendency to increase with economic growth, reflecting the increasing budget deficit on the one hand, and low efficiency of banks burdened with bad debts on the other hand.

The high inflation rate and system instability prompts business units, including banks, to engage in short-term investments that guarantee quick repayment of capital, which, given the high risk factor is a fully rational phenomenon. Unwillingness to save and invest long-term reflects the lack of sufficient stability in the economy and a lack of faith in the distant future. The psychology of operating only in a short-term horizon is the fundamental difficulty to raising long-term capital and bank participation in mortgage credit. The lack of active pension and insurance funds, as well as social security reform, reflect a transitional state of development, although the first positive signals have already appeared. Without greater stability and long-term savings, it is difficult to consider prospects for the growth of mortgage credit in quantitative terms.

Low inflation and a good supply of long-term savings would not remove all the impediments. The credit underwriting process is burdened by a number of problems as well. Some stark examples are concerned with lien security. There is no central lien registry so that the banks cannot check if the same property is being used as collateral for more than one loan at the same time. Banks are 6th or 7th in line among claimants to a foreclosed property, and the foreclosure proceeds are shared proportionately among the claimants. Eviction laws are difficult to enforce. All of these problems are being looked at, but making improvements is consuming much energy and using up a lot of political capital. These fine-tuning changes are the last major campaign that has to run its course before the system will be ready to absorb a high volume of activity. It should also be remembered that a country with acute capital scarcity will have to resolve the problem of which sector should be able to tap this capital.

SUMMARY

The current difficulties in the development of the mortgage credit market in Poland can be characterized as follows:

- lack of reliable information on borrowers;
- administrative and fiscal obstacles in deed executions and title registrations;
- unclear ownership titles and protracted foreclosures;
- lack of standardization of mortgage products;
- low efficiency in the banking sector;
- borrowers "spoiled" by low housing costs in rent controlled housing;

- fear of uncontrollable negative amortization;
- instability of borrower incomes and jobs;
- slow privatization process of the public housing stock;
- uncertain valuation of collateralized properties;
- competition for capital by other, including public, sectors.

The small volume of housing loans, reflecting the modest scale of construction activity and little mobility within the stock, is not creating much pressure for quicker development of a housing finance system. However, it may be expected that continued increases in real incomes reflecting a sustained high growth of Poland's economy, as well as declining inflation, will create more demand for mortgage credit. This should create additional pressure for more dynamic evolution of a mortgage finance system drawing increasing attention from foreign financial institutions as well. Reforming this sector requires reforming many contingent impediments, but some day it will be complete.

NOTES

[1] For an excellent discussion of this problem, see Alain Bertaud and Bertrand Renaud, *Cities Without Land Markets, Lessons of the Failed Socialist Experiment,* World Bank Discussion Paper 227, 1994.

[2] For a thorough description of real estate reforms in Poland, see W. Jan Brzeski, *Emerging Real Estate Markets in Poland,* Working Paper, Cracow Real Estate Institute, Cracow 1995.

[3] The system was able to finance production volume of some 200,000 dwellings annually (5-6 per 1,000 population) with the record of 280,000 set in 1978.

[4] Loans were typically "block loans" granted to coops for an entire investment cycle divided into disbursement (construction) and repayment (amortization) phases.

[5] Other institutions participating in the program are the United States Agency for International Development and the European Bank for Recon-struction and Development, as well as central budget funds.

[6] It is still unclear if Poland will choose to just create a mortgage bond instrument and let any bank issue it, or a special law will be passed to create mortgage banks as specialized institutions.

[7] The mortgage increases the initial affordability by making first payments smaller.

[8] Specifically, payments are increased monthly by either 1/24 or 1/12 of the cost of funds index, depending on the borrower's payment-to-income ratio.

[9] For a thorough analysis of the PKO products, see PADCO - USAID, *Review of the New PKO Mortgage Instruments,* August 1995, Washington, D.C.

[10] In addition to deposit insurance, a supplementary guarantee by the State Treasury will apply to savings amounts in excess of the deposit insurance limit.

[11] For a thorough discussion of suitability of contract savings systems for transitional economies, see Michael Lea and Bertrand Renaud, Contractual Savings for Housing, The World Bank, Financial Sector Development Department Working Paper 1516, September 1995.

[12] Presently, some 400,000 construction projects are in progress, while the annual housing completion rate is around 30,000.