

The Future of Specialized Housing Finance in Europe

by Andreas Zehnder

BACKGROUND

If you wish to make good predictions about a particular product or a particular industry, it is usually advisable to examine past developments because in the majority of cases these will provide the basis for future trends. This also holds true for the institutions specializing in home financing.

A remarkable change in home financing has been observed in Germany since the mid-'70s. Competition has sharpened considerably. Until the beginning of the '70s the market was more or less balanced; real estate financing was largely the domain of specialized finance institutions, namely the Bausparkassen and the mortgage banks. In 1975, almost 70% of real estate loans from all credit institutions originated from these two groups of institutions. Of the remaining 30%, the greatest proportion was accounted for by the savings banks, which primarily operated in the first mortgage business for one- and two-family homes. The secondary mortgage business was covered by the Bausparkassen, while the mortgage banks concentrated on the commercial housing sector and specialized in the financing of rental housing.

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During the course of the '70s the commercial and major banks in particular began to set their sights on the private home finance business. Incorporating private mortgage banks into bank group structures enabled the commercial banks to extend their range of services to include housing finance. At the same time, the mortgage banks increasingly extended their interests to the single- and two-family home business.

By 1995 the share of specialized finance institutions (Bausparkassen and mortgage banks) in the loans awarded by credit institutions as a whole had dropped to 45%, while in the same period the share of the savings banks and commercial banks increased from 25% in 1975 to 50%. [Editor's note: See Figure 3, p. 5, in the article by A. Lambert, this issue.]

As with the mortgage banks, the Bausparkassen have been extensively incorporated into group strategies. All major banks, savings banks, co-operative banks and insurance companies have their own Bausparkassen. Two previously independent Bausparkassen are concentrating their efforts on a "package-financing" strategy with their own subsidiary mortgage banks and insurance companies.

Today all groups of institutions offer almost all elements of home finance: level-payment mortgages with fixed rates of interest for five, 10 and in some cases even 15 years; variable interest rates; finance mixes of mortgages with life insurance, as well as *Bausparen*, that is,

building [contract] saving. Only instruments with interest rates fixed over the entire mortgage term of 25 to 30 years, as was usual practice in the past, have disappeared from the market in the absence of refinancing possibilities. The broad range offered by all groups of institutions has led to a situation in which the borrower usually need only negotiate all requisite financing with one lender. This is so-called "package financing."

'PACKAGE FINANCE'

In order to be able to correctly assess the future prospects of the specialized institutions in particular, it is also important to know how home buying is financed. Despite the shifts on the supplier side, this financing structure has undergone relatively little change over the past 15 years. It takes the following form for the "typical home buyer" in Germany:

- Some 40% of total funding is provided by the home buyer's own resources. This capital is composed of credit at Bausparkassen, banks, savings banks, cash, work of the buyer on his new home ("sweat equity"), and revenue from sales.
- 60% of the total financial requirement is covered by outside funds, one-third of which (20% of the total financing) is accounted for by loans with interest rates independent of the capital market (building-saving loans, employer loans, loans from relatives), and two thirds (40% of the total)

by loans with interest rates which are subject to the fluctuations of the capital market (loans from mortgage banks, commercial banks, savings banks, or life insurance companies).

The relatively high percentage of buyer capital typical of Germany, coupled with the external funding unaffected by the capital market interest rate, has considerable consequences for economic and home construction trends: even marked changes in the interest rates on the capital markets lead to only limited changes in the home financing plans of the individual, so that the financial burden will usually be bearable even if interest rates increase.

Another result of this system is that the number of foreclosure sales and the resultant losses for the credit institutions is relatively small. As the figures for the construction of single- and two-family homes over the past decade show, this area of housing construction has been following a steadier course than rental housing construction. Disregarding scattered regional house price booms and the subsequent drop to "normal" price levels resulting in temporary periods of housing standing empty, the housing market has been largely unaffected by serious price and economic slumps in the past.

By contrast, completely different developments have been observed in other countries, particularly over the past 10 years. Low capital resources of buyers, in some cases even 100% outside loans, and the resultant high level of indebtedness and dependence on capital market fluctuations, coupled with a marked inflationary mentality in numerous countries, have led to great turbulence in the housing markets.

In its annual report for 1991-1992, the Bank for International Payment Equalization (BIZ) in Basle, Switzerland, pointed out that "the relatively high level of debt in the private sector,

particularly of private households, together with receding real estate and stock prices, has amplified and extended the drop in demand in several large countries. . . . During the '80s there was a vigorous upswing in the purchase of long-life consumables, as well as of apartments and houses, which were largely funded by loans. Easier access to housing finance coupled with preferential tax treatment of interest payments in many countries led to a strong rise in mortgage debt."

As a consequence of the economic vulnerability and the outside funding which was greatly dependent on capital market trends, housing construction in the United Kingdom, the Scandinavian countries, France and the Netherlands, for example, slowed significantly in the late '80s and early '90s. In Sweden in particular the number of single-family houses sold dropped 50% in the period 1989 to 1992.

The economic recession in the United Kingdom had a particularly drastic effect on the housing market. By the end of 1992, 600,000 mortgage debtors were defaulting on payments. Some 75,000 to 100,000 foreclosure sales were recorded. For some 1.5 million houses the mortgage debt exceeded their market value. This development is not least the result of finance mixes which are almost entirely composed of loans. The risk buffer provided by the buyer's own capital is completely absent. Added to this was the fact that up to this point it was usual practice in the United Kingdom to take out loans almost exclusively with variable rates of interest. Only during the course of the 1990s did fixed-interest-rate loans begin to become established.

Developments of this nature have not so far been observed in Germany. Despite the low level of homeownership (39% east and west), the construction of single- and two-family dwellings has been stable, not least also to the delight of the Bausparkassen and mortgage banks.

FUTURE DEMAND

The home finance institutions in Germany will be faced with an unaltered high level of demand for financing in the coming years. Experts forecast that in the long term an average of 400,000 new homes in the west and 70,000 homes in the east of Germany will have to be built every year. This assessment is primarily based on the increasing number of households and the rise in living space per household as a consequence of increasing income.

After seven years of sustained expansion, however, reaching record figures in the last year with over 600,000 new homes, the housing construction industry is currently experiencing a downswing. The completion rate of 1995 was not matched in 1996, and new construction is expected to slow in 1997, though maintaining a reasonably high level. A turnabout in this trend is first expected in 1998.

In the medium term, demand for new homes is expected to rise since the great number of young people pushing into the rented home market in the '80s and early '90s will in the future be looking to purchase their own homes as they become young families with children. Citizens in the east of Germany in particular are planning to purchase their own homes in the coming years.

In the west of Germany the federal government aspires to increase the level of homeownership from just under 42% to 50%; this would mean an increase of owner-occupied homeownership of some 3 million dwellings. In the east the goal is to bring the homeownership level from its current 26% to match the west; this would require the doubling of owner-occupied homes in eastern Germany, another 1.8 million homes. The rise in the level of homeownership can be achieved on a small scale by converting rental housing into owner-occupied housing. In the majority of cases, however, new homes will have to be built.

The new housing assistance program in force since January 1, 1996, is primarily intended to provide greater assistance to the so-called threshold households, i.e., households in the middle and lower income brackets. This represents 7 million households in east and west Germany, an extremely large target group.

Added to this is the fact that the development of initiative on the part of citizens in taking precautionary provisions for the future is becoming increasingly important in Germany in view of growing financial difficulties encountered by the public sector and the state pension system, which has resulted in a reduction in social security benefits. Rent-free homes and building-savings as long-term investment instruments to achieve this goal will therefore assume increasing significance in the future.

Not to be overlooked, keener competition in the credit industry has led to institutions attempting to tie clients to their groups for as long a term as possible. This in its turn has led to the supply of a comprehensive range of products along the lines of a package-financing strategy ("from the cradle to the grave"), in order to prevent customers, as far as possible, from taking their business elsewhere. Specialized finance institutions are also involved in such all-round financing strategies. Cross-selling becomes an increasingly viable proposition as the product range is extended.

BAUSPARKASSEN STRATEGIES

Three basic strategies have emerged with particular reference to the Bausparkassen:

- The "package financing" strategy, i.e., a diversification strategy into other markets (BHW and Wüstenrot).
- The cross-selling strategy, in which focal emphasis continues to be placed on the

building-savings business, but other products are also offered within the group (Schwäbisch Hall, LBS).

- The synergy strategy, which provides for the building-saving product "merely" to supplement the range of products (Bausparkassen of insurance companies and of banks).

The tailor-made home finance plan, which has been geared to suit the special situation of the individual customer, is moving increasingly to the fore. This trend—away from standardized home financing models toward individual customized solutions produced on the basis of detailed specialist advice—will most probably be sustained and expanded into the future.

The introduction of new rates has been the Bausparkassen response to the changed customer demand for yield, liquidity and certainty of when a loan would be paid out. The building savers may choose between numerous rates—usually also after conclusion of a saving contract—and thus influence credit interest rate, loan interest rate, saving and redemption installments, size of loan, as well as saving and redemption periods. The Bausparkassen also are increasingly working to fully exploit all sales channels. In addition to independent commercial agencies and part-time staff, they also employ salaried sales staff, marketing companies, stationary sales locations, group partners, cooperative partners and the sales staff of the group.

The Bausparkassen do not only offer varied finance solutions but also offer a range of supporting services. The Bausparkassen are present in virtually all areas of home construction, frequently via subsidiaries or cooperative partners. These services include:

- brokering insurance services
- offering real estate

- cooperating with systems-built house manufacturers
- staging activities on different subjects (e.g., low-cost building, energy-saving, ecological construction, architectural competitions)
- managing real estate.

THE IMPACT OF THE SINGLE CURRENCY

The planned introduction of a single currency in Europe promises to provide positive impetus to the business of the specialized financing institutions. From the German point of view at least, the cost of living and interest rates on the capital markets can most certainly be expected not to be lower, but to tend to rise following the introduction of the EURO. This will benefit building-savers in particular, for example, who are now saving for a loan the interest rate of which is already fixed.

On the other hand, it is precisely building-saving which is so dependent on price stability, as is emerging in the majority of candidate countries wishing to participate in the single currency. As prices rise, the purchase of real estate becomes more lucrative and demand increases. However, inflationary trends lead to problems in the long term, and this also holds true for the real estate market. The developments described earlier in this paper in the different countries in which real estate crises arose, have shown that inflationary trends with excessive prices lead to a crash which can have a considerable negative influence on many areas of the economy, and also in the banking industry.

A fundamental advantage of a single currency is primarily the expansion of the market on the assets and liabilities side. The exchange rate risk is eliminated. It becomes substantially easier to grant loans across borders.

The introduction of the currency union is also expected to make competition on the finance markets even sharper. As far as Germany is concerned, it can be said that the country already has an extraordinarily high density of banks. This means that the citizens have a very high supply of banking services. There is a particularly broad range of finance products for real estate financing in particular. Consequently, the competition in other countries in which this range is not as comprehensive will increase.

ACTIVITIES IN EASTERN EUROPE

The amendment of the Bausparkassen Act in 1991 created the formal framework for activities of Bausparkassen in Europe outside Germany. After the "Iron Curtain" was drawn back, the perspectives of Bausparkassen in eastern Europe improved markedly. An analysis of housing markets and housing finance markets quickly shows the very considerable market potential. If these markets are to be developed, however, land registries must be kept correctly. The inadequacy of such registries would currently appear to present

great problems in the majority of these countries.

Up to now the credit industry in the countries of eastern Europe has not been geared to broad-based financing of real estate or appropriate property conversion or extension measures. There is a lack of long-term finance instruments, and the banks are faced with substantial liquidity problems. There is thus a huge demand on the economic and finance side alike.

On the other hand, the process of economic transformation has been associated with a drastic rise in unemployment and a dramatic slump in productivity and resultant economic growth. At the same time, the rates of inflation in the majority of eastern European countries have skyrocketed. There is a huge gap between private income and house prices, which has been very difficult for credit institutions to close up to now. But since the state alone is unable to supply the population with living space, it is dependent on its citizens taking the initiative. High inflation rates, however, make the long-term financing

solutions necessary for residential real estate very difficult to calculate.

Positive developments in Slovakia and the Czech Republic, which were the first countries to come to grips with economic stabilization and price trends in particular, and where building-saving was introduced in 1992 and 1993 respectively, clearly show that forms of home financing which are linked with a process of saving—such as building-saving—have good chances of continuing the success made in Germany and Austria into eastern Europe. There are now two Bausparkassen in Slovakia and some 800,000 building-savers. The Czech Republic has six Bausparkassen with almost 1.4 million building-savers. This is a great success considering the short time that building-saving has been in operation in these countries.

Building-saving is shortly to be introduced in Hungary. A corresponding draft bill has been tabled. Building-saving is also expected to be introduced into Poland in the foreseeable future.