The Transition in Housing Finance in Central Europe

by Douglas B. Diamond

INTRODUCTION

As of 1998, the countries of Central Europe are nearing the end of a decade of economic, political and social transition. They have struggled to mold new, market-based financial systems out of the institutional and legal legacies of central planning and state direction of investment decisions. One task of that new financial system must be the provision of long-term finance for private investment in housing.

This article assesses the past and near-term prospects for housing finance in four Central European countries: the Czech Republic, Hungary, Poland and Slovakia. The focus is on the policies, institutions and forces shaping the market today; but the starting points and transition process are also covered to provide needed background and perspective.

There are two major conclusions of the report. First, it appears that home buyers in Central Europe are unusually reluctant to borrow, even at subsidized low real rates, unless rates are subsidized below the return on bank deposits.

Second, the Bausparkassen-type institutions, which have been very popular, will not provide the sorts of public benefits expected, but may supplant mortgage or commercial banks as the primary housing lenders.

THE STEPS TO TRANSITION

Similar Starting Points

A review of the transition in housing finance in these four countries of Central Europe leaves a striking impression of similarities. Not surprisingly, the starting points are very similar. However, despite very independent policy evolution, the current status of housing finance is very similar across the region.

There were three main modes of ownership and financing of housing during the Communist era, namely:

1. State/municipal/enterprise rental.
2. Cooperative/condominium.
3. Owner-occupied family houses.

In all of the countries, the initial emphasis after World War II was on the production of state- and enterprise-owned rental flats, with a shift in the 1970s towards greater production of privately "owned" units in cooperatively owned buildings or freehold condominium flats. However, throughout the period, there remained the possibility of obtaining an owner-occupied family house, if one could procure the land and building materials needed to complete it.

The end result was that, despite the state domination of the housing sector for 40 years, the overall housing stock was still predominantly in private hands (unlike in the Soviet Union). As of 1990, the 20.8 million units in the four countries were distributed in the following manner:

- Owner-occupied: 61% (including co-ops).
- Public Rental: 38% (including employer and rental co-ops).
- Private Rental: 1%.

As of 1989, new housing was being financed in several ways. Construction of rental units had been cut back sharply, to fewer than 10% of new starts in Hungary and Poland and about 20% in Czechoslovakia. Cooperatives or condominiums (in Hungary) were the principal form of new housing in urban areas, and these benefited from state grants and deeply subsidized finance from the state savings bank.
Those building family houses also had some access to long-term financing from the state savings bank, at 1.0% to 3.0%, usually for 30–40 years.

The net effect in all four countries was that there was a substantial block of long-term, low-rate housing debt held by state banks. In addition, all of the countries have a legacy of low municipal and enterprise rents originally set at nominal levels and maintenance shortfalls that have yet to be addressed.

From 1990 to 1995, there were several important adjustments in the housing and housing finance sectors in all the countries. Legislation was enacted to provide for the transfer of most state-owned stock to municipal governments and privatization of that stock to sitting tenants. Slovakia and the Czech Republic also provided for the restitution of pre-war rental stock (with sitting tenants at controlled rents).

However, notably, only in Hungary was there a significant amount of privatization during this period. Generally, countries either kept rent levels so low or privatization prices so high that it was more attractive to remain a renter with nearly all of the legal prerogatives of an owner, but lower outlays for maintenance (and lower maintenance). The result was that Hungary was the only country to show a significant increase in the owner-occupied stock by 1994.

All four countries entered recessions by 1990, but followed somewhat different paths out of them. Official figures (which presumably underestimate the growth in the black economy) show bottoms reached in 1993 in all but Poland, which endured a particularly rapid decline, was one year ahead in its decline and recovery.

The countries had a significant divergence with respect to inflation. The two parts of Czechoslovakia brought inflation down rapidly after an initial run-up and have kept it in the range of 10% or less, considered to be supportive of normal housing finance.

Hungary and Poland have struggled with inflation persisting over 15%-20% and thus interest rates over 20%. As discussed below, however, these different inflation environments have not translated yet into significant differences in the use of mortgage finance.

The Momentum of the Past: 1989 to 1992

All of these countries suddenly needed new mechanisms for financing the housing sector, especially construction and renovation. Private-sector finance for private-sector housing was not something that government policy makers or bankers were familiar with as of 1989 in any country.

All the countries had much to learn and understand before a new system for the provision of, and charging for, housing in general and housing finance in particular could be designed, implemented and accepted by the public.

The most advanced in this area was Hungary, because it had grown to depend more on individual households for housing finance and production than the other countries. Although the basic lending mechanism used in Hungary, the below-market, fixed-rate loan made by the state savings bank, was in use in all of the countries, its usage by the general public was far more common in Hungary.

While the other countries emphasized municipal flats or large loans to cooperatives as a means of financing the large-scale construction of panel flats, Hungary had gradually shifted towards the sale and financing of such flats to individuals through the condominium format. In addition, access to land, infrastructure and materials for the construction of family houses was easier in Hungary.

Despite the similarity of such lending to Western-style housing finance, the similarity was only skin-deep. The entire financial system was an artificial construct of monop- oly state-controlled institutions that operated at the behest of central planners and were generally outside the forces of supply and demand.

Thus, funding and pricing loans were not issues for the housing finance sector. The lending and loan recovery processes were designed around the proposition that most citizens worked for the state; the state was integrated with all economic and financial institutions; and economic uncertainty was minimal for the individual. Thus, the creditworthiness of would-be borrowers was evaluated only cursorily and wage garnishment was relied on for enforcing loan recovery.

These difficulties existed for all other sectors of the economy. However, other parts of the economy generally received the bulk of the reform attention in the very first years, accompanied by efforts to keep the housing sector persisting in the same approach as earlier for a while longer.

In addition, with intra-COMECON trade collapsing, continued strength in the housing construction sector was looked to for maintaining employment. Thus, in all of the countries, significant subsidies continued to be channeled into the familiar modes of operating the housing sector in the years immediately after 1989.

Table 1 shows the trend in housing completions, with the 1989 level set at 100.5

In Czechoslovakia (and in the Czech Republic and Slovakia after 1992), the focus was on the completion of public rental and cooperative projects already started. This initial burst of continued subsidy died down after 1990, and there was a period during which it was hoped that the private market, together
with market-rate housing finance, would begin to fill in for state-sponsored construction, without significant subsidies.

However, the number of new houses (not shown) dropped by over 80% in each country between 1990 and 1991 and stayed low until 1995. (The more rapid decline in completions in Slovakia reflects the lack of funding for completing all of the municipal flats that had been started.)

In Hungary, large amounts of additional subsidy were committed to private home buyers through a modified scheme of deeply subsidized mortgage lending, on an amount equal to about 20% to 25% of the cost of a new home, plus a grant for another 10% to 12%.

However, rapid inflation steadily reduced the value of the set amount of subsidized loan and grant assistance, and housing activity shrank. Even so, the number of housing completions eventually fell less than in the Czech Republic or Slovakia, because of Hungary's new commitments of deep subsidy after 1991 and because production in Czechoslovakia had been more dependent on direct state budget support to begin with.

Poland shows the most gradual descent in terms of housing completions. Polish authorities used the housing sector as an economic buffer more than other countries, both by continuing through 1991 to make subsidy commitments for hundreds of thousands of additional units (most co-ops to be constructed in 1992 to 1993) and then by starting up a major new tax subsidy in 1992. The magnitude of the cost of these efforts is reflected in the high burden on the budget of "old loans," which is almost totally due to loans issued after 1986 (earlier loans were not indexed and thus disappeared in value during the hyper-inflation of 1989 to 1991).

The Transition to Market-Based Finance Begins (1993 to 1995)

Table 1. Trends in Housing Completions, 1989 to 1997 (1989 =100)

<table>
<thead>
<tr>
<th>Year</th>
<th>Czech Republic</th>
<th>Hungary</th>
<th>Poland</th>
<th>Slovakia</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1990</td>
<td>80.9</td>
<td>85.0</td>
<td>89.3</td>
<td>74.0</td>
</tr>
<tr>
<td>1991</td>
<td>75.7</td>
<td>64.5</td>
<td>91.1</td>
<td>62.3</td>
</tr>
<tr>
<td>1992</td>
<td>66.1</td>
<td>50.1</td>
<td>88.9</td>
<td>49.1</td>
</tr>
<tr>
<td>1993</td>
<td>57.2</td>
<td>40.6</td>
<td>62.8</td>
<td>41.9</td>
</tr>
<tr>
<td>1994</td>
<td>33.0</td>
<td>40.6</td>
<td>50.7</td>
<td>20.1</td>
</tr>
<tr>
<td>1995</td>
<td>23.0</td>
<td>48.0</td>
<td>44.7</td>
<td>18.6</td>
</tr>
<tr>
<td>1996</td>
<td>26.3</td>
<td>55.0</td>
<td>41.3</td>
<td>18.7</td>
</tr>
<tr>
<td>1997</td>
<td>30.4</td>
<td>54.6</td>
<td>49.1</td>
<td>21.6</td>
</tr>
<tr>
<td>Avg. of 1990–1997</td>
<td>49.1</td>
<td>49.7</td>
<td>64.7</td>
<td>38.3</td>
</tr>
</tbody>
</table>

Each country did choose somewhat different paths towards developing their housing finance system. Many of the details of this process have been reported in earlier articles in Housing Finance International.5

In summary, Slovakia inaugurated a building societies (BS) scheme (modeled after the German Bausparkassen) in November 1992, and the Czech Republic followed in 1993.6 However, the former state savings banks in both countries simply stopped making long-term housing loans entirely.7 Essentially, from 1992 to 1994, there was no mortgage system in either country.6 Commercial bank lending was restarted in both countries in 1995, and these banks have since set up mortgage banking arms.

Hungary halted the deep subsidies to mortgage borrowing at the end of 1993 and started to focus on building a regular market-based housing finance system. The savings bank revamped its mortgage program, which had continued to be very active since 1989, and introduced more appropriate underwriting and loan recovery procedures. The government also worked with the savings bank to provide a more affordable housing loan using the Deferred Payment Mortgage design.

Poland attempted to cut back on the flow of subsidies even earlier, in 1992.8 Already in 1990, Poland had shifted to an inflation-indexed mortgage scheme through its state savings bank, but it still provided relatively low current repayments and a large current and future subsidy from the state. In 1992, this scheme was modified into a regular dual-indexed mortgage, with payments expected to rise with incomes and eventually cover the full accrued interest, supposedly...
with no state-subsidy. It was soon apparent, though, that the scheme was flawed because it set the initial payment unrealistically low. This loan system was reformed to be truly unsubsidized only in 1995.

During this same period, several of the countries started to focus on developing the legal and institutional infrastructure needed to operate an effective private housing finance system. The most basic of these involved removing or diluting the traditional requirement that defaulting borrowers be provided with equivalent accommodation elsewhere. Hungary passed such legislation in 1993 and the Czech Republic in 1994. Hungary also later adopted revisions of the civil code which would permit mortgage contracts to provide for expedited adjudication in cases of foreclosure.

THE ARRIVAL OF MARKET-BASED FINANCE

By 1995, all four countries had made great progress in the most critical arena, macro-economic conditions, including reducing inflation and promoting growth in real incomes. All four had moved towards strengthening their financial systems, especially the banking sector, and also had been developing a better basis for loan recovery, although none have unequivocally succeeded in either regard.

Since then, all four have taken steps towards creating private pools of pension funds that could make a more desirable base for funding mortgages. All four have attempted to encourage competition and innovation in retail banking.

Commonality of Structure

By 1998, all four countries appear to have moved towards nearly the same basic institutional structure for providing private housing finance. This consists of a strong universal banking sector, a deeply subsidized building society sector and some version of mortgage banking as a potential mode of accessing funds for housing from the capital markets.

On paper today, the housing finance systems in all four countries appear to be very similar to the systems in Germany and Austria. This appears not to be a coincidence nor to be primarily because of historical linkages between these countries and the German-speaking countries. The anecdotal evidence is that this occurrence is because of direct efforts by commercial interests in Germany and Austria to develop new fields for application of their proprietary skills and systems.

A part of these efforts appears to have involved promoting the concepts underlying the archetypal model of the German housing finance system. At the core of this model are the specialized "housing savings" institutions (Bausparkassen), where steady savings towards the equity investment in homeownership is rewarded by state-supported premiums; and the low interest rate on savings permits the offering of a low fixed rate on an approximately equal size loan.

In this model, an additional loan up to a very conservative loan-to-value (LTV) ratio is funded through nearly riskless bonds issued by specialized and carefully regulated mortgage banks. Commercial banks play only an ancillary role of offering any additional funding that can be afforded after securing the first two loans.

This model roughly described the reality of housing finance in Germany in the early post-war period. However, the evolution of most financial systems towards less specialization and segmentation has greatly diluted this model in practice.

In modern Germany, the lines between Bausparkassen, mortgage banks and commercial banks are more written in regulation than in the minds of borrowers or even lenders. Nearly all major such institutions are knitted together as affiliates in joint ownership, and their products are sold jointly, as a package. Bonds issued by regular banks have rates almost as low as those issued by mortgage banks, and the "moral character" revealing aspect of a Bauspar savings program is frequently passed over in favor of making a bridge loan immediately or early in the savings program.

Just as this system is more mythological than real today in Germany, the actual structure eventually adopted in each Central European country has varied across countries and significantly from the German model. This is most notable with respect to the mortgage banking structure adopted.

In the Czech Republic and Slovakia, mortgage banking has effectively become an activity subsumed in ordinary commercial banks, looking very much the same as ordinary mortgage issuance by commercial banks anywhere in the world, except to the extent that the mortgages are used as segregated collateral to back the issuance of mortgage bonds.

Since the mortgage banking legislation has preceded the development of deep and robust capital markets, bond issuance is not attractive in any country so far, and only a small share of the funding for loans issued by commercial banks has derived so far from bond issuances. In effect, supposedly German-style mortgage banking in these countries has simply given commercial banks an additional potential tool for raising funds for mortgage lending, not that dissimilar from the use of mortgage-backed securities in France and many Anglophone countries.

Hungary and Poland so far have adhered more closely to the traditional model of mort-
gage banks as specialized institutions operating under special rules (as opposed to ordinary commercial banks issuing specially designated bonds). It is too early to tell whether such an approach offers enough real world value in fund-raising to support the extra costs and inefficiencies of specialized and segmented institutions. There are a number of reasons to suspect that this will not be the case, including the low liquidity of mortgage bonds and the weakness of the basic premise that low-LTV mortgage loans are nearly riskless.

All of the countries have adopted a form of the German Bausparkassen system, with Hungary joining the Czech Republic and Slovakia in 1996 and Poland doing so in 1997. The specifics of the building societies in all of the countries are close in spirit and in substance to the original Bausparkassen model but still vary significantly.

(Many of the most important parameters are noted in Table 2, except for Poland, where the system has yet to be fully defined or start operations.) It is difficult to generalize about them, other than to note that they are all structured around institutions that are legally separate from the commercial banks (but integrated operationally with domestic commercial banks, and usually controlled by one or more commercial banks partnered with a German or Austrian Bausparkasse) and that the BS programs are likely to be the single largest housing-related subsidy recipient and, not coincidentally, the largest housing lenders in each country.

**Table 2. Bausparkassen Systems in Central Europe**

<table>
<thead>
<tr>
<th>Year of initiation</th>
<th>Czech Republic</th>
<th>Hungary</th>
<th>Slovakia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1993</td>
<td>1997</td>
<td>1992</td>
</tr>
<tr>
<td>% Bonus⁹</td>
<td>25%</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>Minimum years to withdrawal of bonus</td>
<td>5</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Minimum years to: 6% loan</td>
<td>5</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Bridge loan</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Housing purpose req.?</td>
<td>None</td>
<td>Yes, until 8 years</td>
<td>Yes</td>
</tr>
<tr>
<td>For bonus</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>For loan</td>
<td>USD 560/year</td>
<td>USD 560/year</td>
<td>USD 570/year</td>
</tr>
<tr>
<td>Max. savings and loan for couple</td>
<td>USD 15,000</td>
<td>USD 12,000</td>
<td>USD 15,000</td>
</tr>
<tr>
<td>Effective rate on savings</td>
<td>12-13% tax-free</td>
<td>16% tax-free¹⁰</td>
<td>11% tax-free¹¹</td>
</tr>
<tr>
<td>Market rate on savings</td>
<td>10-12% taxable</td>
<td>14-16% tax-free</td>
<td>10-12% taxable</td>
</tr>
<tr>
<td>Rate on loans</td>
<td>6% nondeductible</td>
<td>6% nondeductible</td>
<td>6% nondeductible</td>
</tr>
<tr>
<td>Market rate on loans</td>
<td>14-15% tax deductible</td>
<td>25-27% partially deductible</td>
<td>14% nondeductible</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1997 Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net contracts</td>
</tr>
<tr>
<td>Net savings (mil. USD)</td>
</tr>
<tr>
<td>Net loans (mil. USD)¹²</td>
</tr>
<tr>
<td># of loans</td>
</tr>
<tr>
<td>State premiums (mil. USD)</td>
</tr>
<tr>
<td>Premiums/state budget¹³</td>
</tr>
<tr>
<td>Premiums/housing budget¹⁴</td>
</tr>
</tbody>
</table>

**Growth of Competition**

In the 1994 to 1995 period, all four countries established programs of conventional market-rate housing finance through commercial banks. The market leader in three of the cases was the former state savings bank, still the predominant retail banking entity.

In Hungary and Slovakia, the savings bank essentially had a monopoly in the market at that time. In Hungary, it appears that the bank made use of this monopoly to keep spreads high on mortgage lending, with the extra benefit of also keeping returns high on the portfolio of subsidized older loans.

In Slovakia, the continuing influence of the state over the savings bank translated into a below-market margin on housing lending, both diminishing the bank's interest in making such loans and also protecting its monopoly on lending.
In Poland and the Czech Republic, true competition had appeared by 1995. The Czech Republic passed legislation setting up mortgage banks, and soon there were three such banks (associated with the three major commercial banks) competing to lend for housing. In Poland, there had been some competition as early as 1993, and interest was rising on the part of many other banks to develop more of a retail banking activity, so that by 1996 a total of 18 banks were offering housing loans of some kind.

As of 1998, all four countries have at least some competition in the provision of conventional mortgage finance. Slovakia still has the least, with only a relatively few loans being made by the only commercial bank that is competing with the former state savings bank. Hungary is the second lowest in this regard, with just the glimmerings of serious competition for the former saving bank appearing.

Poland has seen expansion to the point today that there are 18 to 20 banks offering some type of housing loan, with four to five banks making extensive efforts. Despite all of this, the old savings bank, PKO BP, still makes, by number of loans, about 80% of the loans. The competitors have carved out a market for larger loans, averaging about USD 20,000.

By measure of number of lenders, Poland is the most competitive market. But by market share, that honor goes to the Czech Republic, where the mortgage bank portions of the major commercial banks are very active in competing for mortgage business of ordinary households, and with no one bank being dominant. In fact, the largest volume of mortgage lending is by one of the traditional commercial banks, apparently because of the slowness of the old savings bank to re-enter the market after having stopped all mortgage lending from 1992 to 1995.

Despite extensive efforts to facilitate loan recovery, bankers in all of the countries report a variety of remaining concerns. However, these concerns are not preventing them from pursuing mortgage lending, although probably not as aggressively as they might with better loan recovery mechanisms.

**CURRENT MARKET ACTIVITY**

**The Small Current Role of Market-Rate Finance**

Despite the presence of funding, declining interest rates and rising competition for customers, there is a remarkably low level of activity in market-rate housing finance. Hungary offers a variety of evidence of this. Overall, Hungary has had the highest rate of issuance of loans per capita and per housing transaction. This is presumably because of its longer tradition of individual borrowing for housing purposes.

For example, in 1993, the last year in which almost all housing loans were subsidized, about 240,000 loans were taken by individual households (out of 3.9 million households). This massive number was boosted by 126,000 loans for utility connections and 71,000 loans for unit renovations, both of which were commonly recognized to be used primarily to capture deep subsidies, not necessarily because of a compelling need for financing. About 43,000 loans were taken for home purchase, although many of them were also obtained primarily to capture the deep subsidy.

In almost all cases, the effective, post-subsidy rates on such loans implied a negative real rate and a nominal rate lower than that on savings deposits. However, 1993 was the last year of such pervasive subsidy for housing loans. The subsidies were removed from all but loans for new construction, and even there the effective rate rose to above the deposit rate, eliminating the outright income-generating aspect of the financing.

Subsequently, loan activity has declined sharply. In 1997, about 19,000 housing loans were taken for all reasons, although the pace of housing activity was higher than in 1993.

Many of these loans were made under a grandfathered "youth savings" program that conveys deep subsidies. Netting these out, there were about 3,600 loans made to finance the purchase or construction of new housing, implying that only 13% of the roughly 28,000 acquisitions of new homes in 1997 utilized such a loan.

Striking results are also seen in the market for existing houses and renovations. At full market rate of 28% to 29% (a real rate of 12% to 13%, partly due to the monopoly pricing of the savings bank), only 5,700 buyers of existing homes, no more than 10%, took such a loan. Loans for renovations had declined from the 71,000 in 1993 to less than 5,000 in 1997, while the amount of renovation activity probably increased.

Similar evidence comes from the Czech Republic. As noted above, there are three banks in the Czech Republic competing to make housing loans. They are assisted in that endeavor by two major subsidies, (1) a 4% buydown for 20 years for new housing; and (2) tax-exemption of profits from the mortgage business, as well as the fact that nominal and real interest rates are substantially lower than in Hungary. As a result, spreads are lower on mortgage loans, and the net after-subsidy cost to borrowers was almost as low as inflation.

Buyers of new homes were facing a real rate of close to zero, and, because nominal rates were only around 12% to 14%, maximum loan amounts were reasonably large. Despite this nearly ideal circumstance, only
1,300 loans, financing 1,860 units (even many owner-occupied houses have more than one unit), were originated by all banks for new housing. Usage was no higher than 15% of new home buyers. 

Slovakia and Poland also contribute to the overall picture. Slovakia has had relatively low real lending rates but no subsidies to push them into being negative. Lending was restarted in 1995 and was popular originally for renovations; but it has languished since 1996, when the real rate rose from 4% to 5.5% and subsidized competition began by building societies and a State Housing Fund. In 1997, only 1,200 loans were made, for both new and existing housing, in a potential market of at least 20,000 housing transactions.

Poland presents the clearest evidence, since there are no finance-related subsidies at all, tax or otherwise, and there has been an active competition for several years. Real lending rates appear to have been in the range of 10% to 12%, but this reflects not just high margins but also higher government real rates.

The spread over deposit rates appears to have been about 7% to 8%, lower than in Hungary, possibly due to the greater competition. Unfortunately, there is no reliable data on lending volumes nor really even of housing activity to be financed, but informed observers estimate that 30,000 loans were made in 1997 for home purchase, of which an estimated 12,000 were for new housing.

Since probably 70,000 to 80,000 new units were subject to financing then, and probably 100,000 to 150,000 existing units, the overall usage rate must be between 10% and 20%, possibly higher than in Hungary but not by much. (Notably, though, market observers feel that volume is growing fairly strongly.)

Table 3 summarizes the usage rates for market-rate finance in all four countries and also notes the explicit effective cost of borrowing in each case. In general, such loans are used in fewer than 15% of actual transactions, and the usage rate does not appear to be sensitive to the real cost.

High Real Rates; Reluctant Lenders or Reluctant Borrowers?

With usage rates such as these, one could conclude that the development of a better housing finance system has not, and perhaps will not soon, have significant effects on the functioning of the housing sector. Thus, it is an important question as to why usage rates are so low.

This question was posed to observers in each country. The common view in Hungary and Poland was that the relatively high real interest rates have discouraged borrowing. In Hungary, inflation has declined more than interest rates, thus opening up a spread of about 12% between inflation and rates charged by the largest lender (including servicing fees). These very high real interest rates may seem to be a good reason why fewer than 1 in 10 buyers of an existing home take out a loan.

However, as noted above, in Slovakia and the Czech Republic, real and nominal rates have been much lower, but loan usage has not been much higher. The perception there seems to be that the public is put off by the presence of nominal rates much higher than previously charged (i.e., 1% to 3%), and market rates will have to come down to 6% to 10% to arouse interest.

Another common explanation is that high inflation has kept nominal interest rates so high that the amount that can be borrowed is quite limited. However, this was not such an issue in the Czech Republic and Slovakia, where mortgage rates were only 11% to 12% in 1995 to 1996.

Similarly, the public in Hungary has not generally accepted the option of taking out loans that mimic those in lower-inflation countries (i.e., that reduce their short-term loan repayment burden by deferring a part of the repayment), although Poles have made heavy use of some amount of deferral (perhaps because they have understood it better due to their period of hyperinflation).

In both sets of countries there is also a perception that lenders are skeptical enough about the "politics" of loan enforcement, whatever the legal and procedural situation, that they are being conservative in underwriting and pricing housing loans.

This introduces the possibility that the lenders are employing non-price rationing or

<table>
<thead>
<tr>
<th>Country</th>
<th>Housing Use</th>
<th>Effective Real Rate</th>
<th>Spread over Deposit Rate</th>
<th>Share of Potential Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>New housing</td>
<td>0%</td>
<td>0–2%</td>
<td>&lt; 15%</td>
</tr>
<tr>
<td>Hungary</td>
<td>New housing</td>
<td>1%</td>
<td>2%</td>
<td>&lt; 15%</td>
</tr>
<tr>
<td>Hungary</td>
<td>All other</td>
<td>12%</td>
<td>13%</td>
<td>&lt; 10%</td>
</tr>
<tr>
<td>Poland</td>
<td>All</td>
<td>10–12%</td>
<td>7%</td>
<td>&lt; 15%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>All</td>
<td>5%</td>
<td>4%</td>
<td>&lt; 10%</td>
</tr>
</tbody>
</table>

HOUSING FINANCE INTERNATIONAL
screening devices that are cutting down on the number of households who are eligible. Perhaps it is the reluctance of the lenders, either instead of or in addition to the borrower’s price sensitivity, that is slowing the growth in housing finance.

The evidence seems to contradict all of these views. It appears that, although households are very reluctant to borrow at high real rates, subsidizing real rates to much lower, but still positive, levels does not increase demand by much.

Moreover, households will borrow when the loans convey a direct cash subsidy (as in Hungary in 1993 and a variety of low-rate loan programs today) and banks are willing to make loans when people are willing to take them (competition seems to be fairly intense).

Instead, the only consistent explanation across all of the experience within the region is that Central Europeans are averse to borrowing for housing, unless the act of borrowing conveys a grant element. More specifically, credit usage is low in all countries and among all sub-categories of borrowers, even in the face of subsidies reducing the effective real rate to relatively low levels, unless credit is subsidized enough that borrowers can actually make money by taking credit. Moreover, there is little evidence that lender reluctance, while perhaps quite strong, is the decisive element.

**Why Are Households So Reluctant to Borrow?**

One useful way of recasting this question is to ask how the great majority of home buyers could buy without using any private-sector long-term credits. To this analyst, the operative reasons have to do with certain unique aspects of Central European demography and real estate markets.

First, the demography is one of slow growth or actual declines in population, although with some trend towards net growth in households. This implies that, on average, there is only one descendent household entering the housing market for every household leaving the market through moving in with children or death. Second, most households are either de jure or de facto homeowners. Even tenants in Central Europe have effective occupancy rights, rights which are valuable because of rent levels that do not cover any capital recovery and sometimes not even regular maintenance. The situations deter them from moving if these rights are not very saleable or give them a significant cash equity stake in their unit if the rights are saleable.

Third, whatever debt that was taken on to acquire that current unit has been practically eliminated through the process of inflation since 1988. Putting these three conditions together implies that a very high percentage of would-be buyers in Central Europe have access to significant cash resources for housing purchase, either from their current unit or from the unit of their genealogical forebears.

Of course, not all would-be buyers are this fortunate. Basically, the disadvantaged group includes young couples without access to parental or grandparental home equity or those who were living in very low-value (or illiquid) units at the time that “socialist” property was generally allocated to the current user. These households could be a significant group among those 10% to 20% who do use credit. In addition, there are those, especially the newly upwardly mobile professionals, who want to supplement their cash position to buy a better house.

But this explanation still leaves an important mystery, which is why more households, whatever their cash position, do not use at least some market-rate credit to enhance their ability to afford an even nicer house. Standard economic theory would suggest that, in the absence of major fixed transactions costs, most households would use the opportunity to borrow based on their future income to expand their consumption of long-lived consumer durables.

An ad hoc but realistic possibility is that Central European households have not (yet) fully embraced the consumerist ethic of Western Europe and the United States, at least not sufficiently to pay any significant effective price for consumer credit for truly discretionary spending.

A variation on this theme is that whatever discretionary borrowing they might want to pursue is being pre-empted by purchases of other long-denied consumer durables, especially automobiles. Observers in Poland and Hungary have noted a willingness to take on large debt burdens to buy a car that can actually cost more than a house.

Another way of expressing the same attitudinal explanation is to assert that households in Central Europe are not comfortable with spending the 25% to 30% of their current income on housing (usually not including utilities) which is commonly observed in market economies. Instead, they may perceive the proper allocation of current income for housing to be 10% to 20%, including utilities, leaving little room for debt service. This may reflect a reluctance to abandon the notion that housing is something which the state (or parents) should be heavily subsidizing.

This implies a profound divergence between the presumptions underlying the promotion of housing finance in transition economies, where almost all calculations assume that households wish to borrow as much as they can, and that 25% to 35% is a reasonable effort ratio.
If this proposition is correct (and it is supported by the empirical observation that those who do borrow average a 15% to 20% effort ratio), it may be articulated by the public as "housing is unaffordable," even though by developed country norms of an appropriate allocation of income, it may be affordable, just not while maintaining the level of consumption of other things (cars, clothes, vacations, cigarettes) that is expected.

This view would suggest that a second process will have to take place before the housing and housing finance markets fully develop in Central Europe, a process of adapting expenditure patterns to true relative market prices.

Support for this distorted public perspective can be seen in the strong political currents in all the countries towards introducing deep subsidies for new construction. It is also consistent with support of public subsidies to building societies, which allow many households to borrow at low enough rates (below deposit rates) that replacing the use of some of their available savings with a BS loan makes sense.

As noted above, some observers perceive that an equal or greater part of the problem is reluctance by lenders to lend. In addition to expanding the real lending rate, such a reluctance might take the form of lenders being unduly harsh on evaluating or processing would-be borrowers, presumably because of nagging concerns about the robustness of loan recovery mechanisms or managerial lethargy. Some concern about loan recovery seems appropriate, given the remaining holes in the net of rapid foreclosure, sale and eviction.

It is not known to what extent this is a major cause of low borrowing volumes.25 However, it is notable that usage rates are not much higher in Poland and the Czech Republic, where competitive pressures are more active.

There also does not seem to be much anecdotal evidence of would-be borrowers being turned down or discouraged. Where this reluctance may be of greater importance is in the lack of extensive marketing efforts, of the type that are a hallmark of all building society roll-outs in Central Europe. Such marketing would contribute to greater awareness of financing options but may not be able to overcome an antipathy towards earmarking more income to housing.

THE FUTURE OF HOUSING FINANCE IN CENTRAL EUROPE

One might expect that, with the Central European countries having adopted the German model of housing finance, housing finance will develop in a manner similar to what it is today in Germany. This view is reinforced when one hears market participants in those countries fully enmeshed with the German institutional structure (all but Poland) speak about how "households will soon be able to build on their building society loans with a mortgage bank loan and maybe even a commercial bank loan." To this analyst, however, the near-term prospects appear quite different.

Most important, the role of the building societies will probably be quite different from that of the Bausparkassen. In the classic German model, a loan from a Bausparkasse is perceived as serving two purposes, both viewed as serving the social goal of facilitating homeownership.

First, it reflects the successful completion of a reasonably long period of steady payments towards a housing goal, thereby promoting and confirming the creditworthiness of the borrower.

Second, the state subsidy helps the borrower build a larger down payment and reduces the loan-to-value (LTV) ratio on a first mortgage. Because the Bauspar loan itself takes second rank to the larger and longer-term loan from a mortgage bank or other source, it supports the traditional mortgage bond structure based on first mortgages with low loan-to-value (LTV) ratios.

Regional Factors Limit Building Society Potential

So far, the signs are that the BS systems will not fill the same roles in Central Europe, at least in the near future, because of special circumstances specific to the situation in the region.

First, until market interest rates come down to EU levels, most would-be Central European home buyers will need to have access to at least 30% of the house price in cash (and generally more than 50%). As noted above, this is actually not such a challenge for many if not most because of the demographic trends in the region and the high levels of housing equity that are common.

In any case, the implication is that, if much of this funding is already available from banks and other sources six years ahead of the home purchase (either from the would-be buyer or parent), it can be transferred steadily from an existing account into a BS account. In this case, commercial banks or mortgage banks will not learn much about the creditworthiness of would-be borrowers of conventional loans.

Moreover, BSs may find that their default rates on home purchase loans are not that different from those for loans by commercial banks, since their borrowers also may be subject to payment difficulties once all of their free cash is invested into their home.

Second, also because of the relatively high levels of inflation and interest rates, the state premium is primarily going towards preserving the real value of the household’s savings.
in the face of large negative rates of return on the saving contributions.

Thus, there is little additive amount accruing to the households savings or downpayment capacity, as compared with the same saving in market-rate deposits. Because of this, the BSs are perceived by the public as being primarily a method of accessing a subsidized loan, with a rate almost as low as the pre-1989 system of subsidized loans, not as a source of additional downpayment.26

Third, the BS system may supplant, as opposed to complement, the market-rate first mortgage system. In most cases, if a household is paying off a maximum loan from a BS over five to eight years, this will involve 10% to 20% of household income already (except at high levels of income).

The presence of the BS system practically assures that most conventional loans will not exceed a 20% to 30% LTV in the near future. When a conventional loan is less than 50% of the cost of the house, there is no reduction in default risk on that loan associated with a lower LTV ratio. Thus, there is no benefit to the functioning of the "German-style" mortgage banking sector from subsidizing the BS system.

A further aspect of this analysis is that the BS systems do not even expand the borrowing capacity of the participants, because of the relatively short terms of the BS loans. A BS loan for five years (as in Hungary) at 6% has a payment that is only 10% lower than that on a market-rate loan at 25% for 15 years. The net result of the BS system is a negligible gain in access to funding (although a substantial subsidy on interest paid).

A final implication is that the operations of the building societies will tend to keep the loan volumes at mortgage banks or commercial banks relatively low. As noted, there is only limited capacity and interest for taking on additional market-rate finance in any case, and whatever capacity and interest there is may be met in most cases by the maximum size BS loan for a husband-wife family (and possibly adding in borrowing rights earned by parents or other close relatives).

The most likely remaining market for commercial bank (or mortgage bank) lending would be for higher income urban home buyers, who will be more interested in such loans both because they have the capacity to borrow far more than the maximum BS amounts and because they will be wanting to buy houses costing more than the housing equity of their parents or grandparents.

While the value of such loans may be significant, the number should be relatively small and perhaps not sufficient to support a very competitive market supply. In addition, if volumes are stifled in this manner, it will become even more unlikely that mortgage bond issuance will develop as a meaningful source of funding for housing (it may become so for commercial real estate).

It is very likely that one day the nominal and real interest rates in the Central European countries will come more into line with those in Western Europe. When that happens, loan affordability will expand, maximum LTV ratios will be utilized, and public policies that facilitate higher maximum LTV ratios will become more pertinent.

If this is combined with an expansion in the willingness of households to borrow for housing, these housing finance systems will tend towards the German model and perhaps even the German reality of formal segmentation but effective integration.

Near-term Outlook

In the near-term, however, these four countries seem to be converging on housing finance systems that feature the following:
NOTES

1 These figures are based on data in Hegedus, J.; Tosics, I.; and Mayo, S., "Transition of the Housing Sector in the East Central European Countries," Review of Urban and Regional Development Studies, 8, 1996.

2 It should be noted that the apparent low levels of activity in Slovakia and the Czech Republic are in the process of being reversed, with both countries reporting housing starts in 1997, fed by strong subsidies, at 300% to 400% of the levels at their lowest point.


4 In direct translation, the names of these institutions usually means "construction (or housing) savings banks," but in Central Europe, they prefer to be called "building societies" in English and that usage is adopted here.

5 In contrast to Hungary and Poland, the Czech Republic and Slovakia did not have the problem of inflation making housing loans unaffordable. Perhaps because of this, there was no effort to deeply subsidize mortgage lending. In the absence of a deep subsidy program, the savings banks apparently did not feel any pressure to offer long-term mortgages at all.

6 The new BS system could not play this role because such systems must start with an initial period (four to six years in these countries) of savings before low-rate loans can be made available. Loans can be made by building societies after two years or so, but at a full market rate, and banks were back in the mortgage business by 1995.

7 It is said that the cutback was only "attempted" because (1) another large subsidy was installed at the same time, the tax deduction discussed below, and (2) an implicit subsidy to lending was introduced as well.

8 The low level of initial payment made these loans very affordable but made it very likely that the accruing deferred interest could not be amortized over the maximum term. Thus, while these loans were explicitly unsubsidized, the public and eventually public officials recognized that the government would be forced to subsidize them ex post.

9 The bonus is the percentage of annual savings matched by the government. In Slovakia, the bonus had been 40% prior to 1997.

10 Return was 18% for contracts started in 1997.

11 Return was 13% prior to 1997.

12 These include only loans to customers, not loans to other parties.

13 Bonuses are paid 14 months after a savings program is started. Thus, no bonuses were paid in Hungary in 1997.

14 This item is for 1998. The "housing budget" used here includes only those expenditures designed to support current activity in the housing market. It excludes expenditures on "old loans," housing allowances and similar items. See individual chapters in full report for more detail.

15 Housing loans granted by mortgage banks were given three advantages: (1) the 4% subsidy if for new housing, (2) tax-exemption of the mortgage banking business and (3) tax-exemption of mortgage bonds (very few issued so far).

16 In addition, thousands of households received "loans" at zero interest rate from their employer or local governments. These were effectively grants and are not included in these figures.

17 Because these loans benefit from a 4% buy-down in the interest rate for the first five years, and the repayments (not just the interest) on such loans were further eligible for a tax credit of 20%, the effective rate of interest was reduced from 27% to 18%, almost as low as the inflation and deposit rates.

18 It is difficult to be more precise. Housing starts were in a steep increase, and it is not clear exactly how many were for private ownership and at what point financing was being arranged. A very conservative approach would be to only consider starts of family houses (excluding all apartments) and average over 1996 and 1997 starts. This yields an average potential market of 13,500 a year, implying that less than 15% of buyers utilized a bank loan.

19 Some buyers of new homes are receiving grants (Hungary), tax savings (Poland) or low-rate state loans (Czech and Slovak Republics). But even these supports would leave at least half of the cost to be covered in other ways.

20 This situation does not mean that the arrival of each new household will be matched by the departure of a household composed of ancestors of those specific people. But the decline in birth rates over the last generation makes it likely that most new households will involve descendants who have some significant claim on the housing equity of a household already ceased, or about to cease, existence. In these countries, the tradition is to pass that equity on to the next generation, not to consume it.
21 In Hungary at least, this situation is reflected in an apparent tradition of better-off parents buying a flat for their children, perhaps from the proceeds of their parents' housing equity. Now that more than one flat can be owned, such activity is often being done in advance of the child's living independently, and such flats are a major source of a growing private rental market.

22 A slightly different perspective is that households are too insecure about their economic circumstances to commit to a large fixed payment out of their regular income (literally "mortgage their future") for increased housing consumption (but will for cars on a shorter timeframe).

23 Marketing surveys in Hungary have found a willingness to pay 30% of income in car payments, but only 10% towards a housing loan. Another interesting finding: 70% say it is shameful to need a loan to buy a house.

24 This is not necessarily inconsistent with the willingness to save a large amount out of regular income towards a house purchase and especially saving 100% of windfalls, a frequent practice in Central Europe.

25 There is some evidence from Poland that stronger competition among commercial banks leads to both easier approvals and more aggressive marketing that can change attitudes.

26 Some systems are offering high enough rates of return that the completed savings are somewhat larger than if saved in a bank. This could translate into at most an extra 2% to 3% higher share of house price covered by the downpayment.