

# HOUSING FINANCE INTERNATIONAL

The Quarterly Journal of the International Union for Housing Finance



- ➔ **Recent Developments in the Housing Market in Poland**
- ➔ **Mobilising Pension Assets for Housing Finance Needs in Africa – Experiences and Prospects in East Africa**
- ➔ **Integration of Residential Mortgage Markets of Turkey and European Union in Light of Recent Regulation in Turkey**
- ➔ **The Home Mortgage and Real Estate Market in Shanghai**
- ➔ **Rajiv Gruha Kalpa: A pro-poor housing program in Andhra Pradesh, India**
- ➔ **The Establishment of the Real Estate Regulation and Supervision Agency of Turkey (RERSAT)**



# International Union for Housing Finance

## Housing Finance International

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# Editor's Introduction

↳ By Andrew Heywood

Housing market commentators and readers of HFI are unlikely to be surprised by the statement that house prices can fall as well as rise. Increased volatility in many markets has been a feature of the past decade and is the subject of the first article in this issue of HFI. Professor Jacek Laszek offers an incisive account of the boom and downswing in the Polish market prior to 2008, analysing the relationship of price and demand to supply in the context of an unsustainable increase in foreign denominated lending and a range of other economic and demographic factors.

While we are accustomed the fact that house price levels can fall, until recently, outside of a small group of academics, the notion that home ownership levels could fall over the longer term and that other tenures could partially supplant owner-occupation has received little or no attention. Yet home ownership levels are falling in a number of markets, as Christine Whitehead pointed out in the Winter 2010 issues of HFI.

In the UK the rate of home ownership has been dropping for eight years and is now back to 1991 levels. There has been a corresponding steep rise in the number of households in the Private Rented Sector (PRS), which has probably now overtaken social renting as the second largest tenure in England. The causes are various but can be summarised briefly:

- A long term decline in affordability leading to a drop in the proportion and numbers of first-time buyers and to a decline in ownership amongst younger age groups.
- The development of a more conservative mortgage market in the wake of the banking crisis of 2007-2008.
- A shift in the tax system towards favouring landlords rather than owner-occupiers.
- Increased inequality of income plus more mobility and insecurity of employment.
- Poor pension provision.
- The transfer of a range of social costs such as welfare and higher education from the state to individuals.
- Demographic factors.

The UK is not alone. Home ownership levels have fallen in a number of markets including the US, Australia and some European states such as Finland and Ireland. All this is beginning to raise the question as to whether home ownership really is the "natural" tenure of globalised and liberalised economies; an assumption that was unchallenged a decade ago.

All this raises very significant issues, not just about tenure-mix itself but about the consequences of a decline in home ownership. Many Governments have transferred welfare spending from the State to individuals in recent decades and such a transfer has often been justified in terms of an increase in private housing wealth amongst those individuals. The relationship between home ownership and macro-economic performance is another key issue where agreement is by no means universal.

These and a range of other issues deserve to be raised in forthcoming issues of HFI; change in the balance of tenure could well be the next big issue. If you feel able to contribute on declining home ownership, growth in the Private Rented Sector or any other tenure related issue please get in touch.

Our second article also touches on issues relating to access to home ownership. James Mutero offers a fascinating analysis of the actual and potential use of pension funds to finance the development and/or purchase of homes in Kenya, Uganda and Tanzania. This article has relevance well beyond East Africa.

The possibility of Turkish entry into the European Union seems to be a perennial issue. Belgin Akçay provides a valuable perspective on an aspect of this wider debate in an insightful comparison of mortgage markets in the EU with that of Turkey in the light of recent regulatory change in Turkey and the latest proposals by the EU Commission. She provides a helpful assessment of the potential for integration of EU and Turkish markets. With EU markets themselves so little integrated one suspects that this is a rather long-term project.

Shanghai has been seen by many as China's historic window on the wider world. Professor Jien Chen demonstrates that it is also a leading indicator of the state of the Chinese housing and

mortgage markets. He traces the development of the private housing market in Shanghai and analyses the efforts of the Chinese authorities to damp down its volatility.

Francis Eddu offers an important insight into the Rajiv Gruha Kalpa programme in India. This is a pro-poor programme. It focuses on providing access to housing finance for those who would find it difficult or impossible to gain acceptance via conventional mortgage routes. Based in Andhra Pradesh, this state supported project has real potential. The article complements recent HFI contributions on India in adding to the analysis available on this large and diverse market.

Our final article in this Summer issue is again from Turkey. In this second of two articles Yener Coskun provides a serious account of the working of the Turkish real-estate market argues for the establishment of a new Real Estate Regulation and Supervision Agency to oversee that market. Again, this article adds to a growing bank of recent articles on Turkey that should be of real assistance to researchers and professionals.

*"The End of the Affair: implications of declining home ownership"*  
by Andrew Heywood

This report analyses the causes of the continuing fall in home ownership in the UK and the corresponding growth in the Private Rented Sector. It also examines the implications of this profound change for Government and for the affordable housing sector.

Published by and available from the Smith Institute [www.smith-institute.org.uk](http://www.smith-institute.org.uk), June 2011.

# Contributors' Biographies

**Professor Jacek Łaszek** has many years of experience in Polish real estate market. He wrote his PhD thesis and habilitation at Warsaw School of Economics where since 2006 he has been holding the Professor position. Parallel to his academic carrier he has gathered business practice. At the beginning of 90' as a member of the advisory board to deputy prime minister Leszek Balcerowicz, he took part in the design of the fundamentals of the housing market in Poland. He continued his work first as a leader of the World Bank housing project in Poland and later in USAID. Between 1998 and 2001 he worked in ING, taking part in Mortgage Bank project and management of building society. He also ran a real estate development investment. Since 2001 he has been monitoring the housing market as the advisor of the President of the National Bank of Poland. Since 2007 he has become a leader of the unit developing more reliable indexes of housing prices in local markets in Poland.

**Mr James Mutero** is a Senior Associate of Matrix Development Consultants, Kenya. He holds doctorate and master's degrees from the University of Cambridge (Department of Land Economy) and a bachelor's degree in Building Economics from the University of Nairobi. Over the last 30 years his work has focused on housing finance, housing policy and urban development. Between 1972 and 1985 he worked for the Kenyan housing ministry. During the last 20 years, as a consultant, Dr Mutero has acquired wide experience in Africa and the Middle East, advising governments on housing policy and housing finance.

**Prof. Dr. Belgin Akçay** holds a BA degree in Economics from 9 Eylül University and received a MBA degree in Economics from Ankara University. Also, she, who got the technical scholarship from British Council, received a MBA degree in Economics Development from Leicester University, United Kingdom. She obtained Ph.D from Gazi University. She, who was a Post-Doctoral Research fellow at Pennsylvania State University, U.S.A during 2000-2002, was a visiting scholar in the same university in 2009. She has been working at Ankara University since 2002. In addition to her academic experience, she has worked in different positions at government including; adviser to the president of Housing Development Administration, Prime Minister's Office (2002), head of finance department in Housing Development Administration, Prime Minister's Office (1998-2000), adviser to Minister of State (1997-1998), adviser to National Real Estate and Land Development Project, Prime Minister's Office (1996-1997), Adviser to Minister of State (1992). She is the author of many articles about housing finance and mortgage markets.

**Professor Jie Chen:** Associate Professor, School of Management, Duty Director of Center for Housing Policy Studies, Fudan University, Shanghai 200433, China; Tel: 0086 21 25011106; Postal address: Guoshun Road 670, Shanghai 200433, China; Email: jiech@fudan.edu.cn

**Dr. Francis Eddu** is a chairperson of the Society for Economic and Environment Development (SEED) in Hyderabad, India, and also a consultant. He has over 15 years work experience in the development sector. He has research interests in developing countries' urbanization, including urban housing issues.

**Mr Yener Coşkun** is senior specialist at the Capital Markets Board of Turkey and holds MRICS designation. The author spent 10 months at Wharton School and PhD Candidate at Ankara University Real Estate Development Department. Yener Coşkun has two published books and several journal articles on capital markets and housing finance.

# Recent Developments in the Housing Market in Poland

↳ By Jacek Łaszek

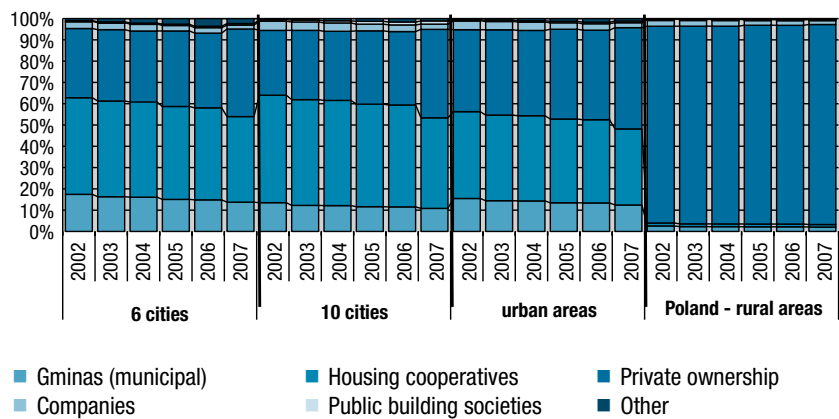
## 1. Basic Proportions and Mechanisms of the Private Housing Sector in Poland

The Polish private housing sector in 2011 comprises mainly multi-family flats located in major cities and in some medium size towns, as well as single-family houses located mainly in small towns and rural areas (Figure 1). While the latter even in the socialist era were privately owned, the development of the sector in the largest cities was associated with privatisation and reprivatisation of council and company flats as well as with housing development after 2000. Some importance should be also attributed to transformations of the resources of housing cooperatives which were practically the only supplier of housing units in multi-family housing in the period of 1970-1990. However the so-called cooperative member's ownership rights in relation to the flat are weaker than under full ownership although it is similarly valued by the market and during the last twenty years the position of the cooperative members' position has strengthened and a small proportion of flats have been transformed into full ownership.

The Polish private housing sector offers virtually no apartments for rent. This is a result of a very far-reaching legal protection for the tenant and the associated risk to the owner. A small stock of housing units for rent which has existed since before the war is also additionally subjected to a restrictive control over rents, leading underinvestment and depreciation of the value of the properties.

Despite privatisation, significant housing stock (approximately 10% according to the Central Statistical Office – GUS) is state-owned, including in the major cities. The value of it is strongly depreciated, but frequently located in advantageous locations. The weakness of local housing policies and the above mentioned over-restrictive

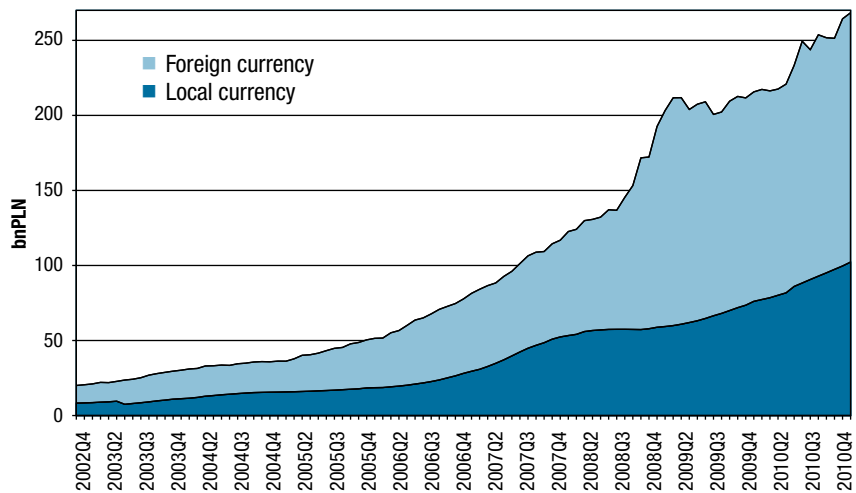
**Figure 1 Structure of Dwellings in Poland by Type of Ownership**



6 cities – 6 biggest cities: Gdańsk, Łódź, Kraków, Poznań, Warszawa, Wrocław  
 10 cities – 10 remaining provincial cities: Białystok, Bydgoszcz, Katowice, Kielce, Lublin, Olsztyn, Opole, Rzeszów, Szczecin, Zielona Góra

Source: own calculations based on data from Central Statistical Office - GUS

**Figure 2 Outstanding Housing Loans**



Source: own calculations based on data from National Bank of Poland - NBP

law on the protection of tenants mean that this resource is not rationally used, particularly for social purposes.

The housing policy was declaratively aimed at housing units for rent and for those with social problems, but in fact it supported privately-owned housing units. Although after the change of the regime changes in the sector were very slow due to the strong sector lobby and the impact of the policy, significant errors were avoided, especially large grant programmes which have a destabilising effect on the economy and the sector. Despite the social phraseology and sufficient resources, no relatively coherent system for satisfying needs has been created thus far, especially for lower income households on the basis of public resources and housing units for rent.

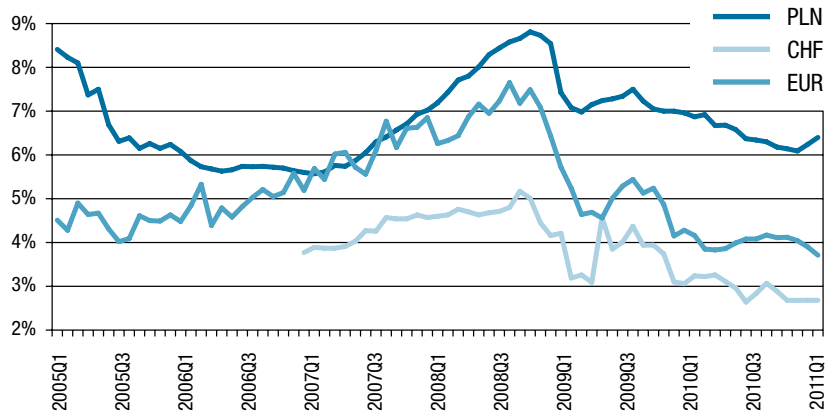
In the 1990s the development of the sector was very limited due to high inflation and lack of market institutions and regulations. The property development sector emerged after 1996, and mortgage financing developed on a significant scale after 2000. The financial sector, which in the 1990s was developed in cooperation with international organisations, is based on universal banks, while lending is funded by deposits. In the period of 2002-2008 loans denominated in foreign currencies dominated and were refinanced on the European capital market. Competition in the sector was high, as reflected in falling margins (Figures 2, 3, 4).

Construction build by developers is concentrated in major cities, as are outstanding mortgage loans (Figures 5, 6). Mid-sized and small towns, similarly to rural areas, are dominated by single-family housing, mostly built under the self-built system, and loans are complementary to the builder's own resources. In the largest cities, despite a large number of developers the degree of concentration of production is, for this market, high.

The size of housing developments varies over time and is highly diversified in terms of spatial planning (Figures 7, 8); however the largest cities dominate where until now two cycles have occurred. The mechanism of the first of them, in the early 2000s, was based on rigid short-term supply, adjusting with 3-4 years delay and variable demand, enhanced by the effects of fiscal stimuli. While the second, current cycle, was associated with rapid economic growth and a credit boom. As a result, the largest scale of the housing development was observed in locations where prices and therefore developers' profits were highest.

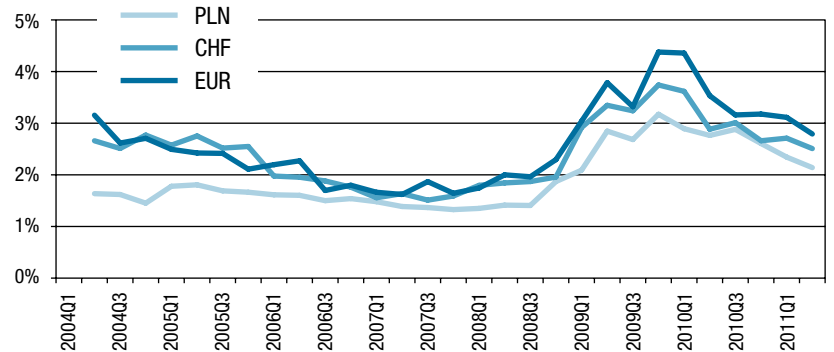
While during the transformation the primary factor affecting the sector was the privatisation

**Figure 3 Interest Rates on New Housing Loans**



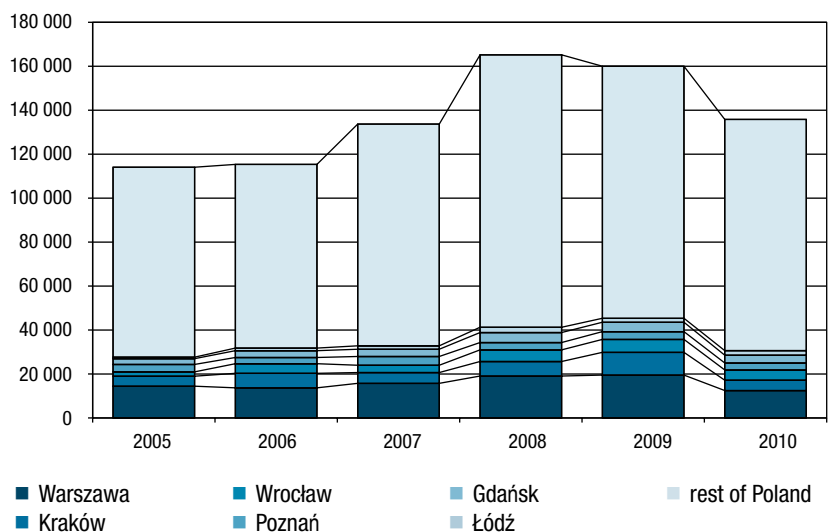
Source: own calculations based on data from NBP

**Figure 4 Margins on New Housing Loans**



Source: own calculations based on data from NBP

**Figure 5 Dwellings Completed**

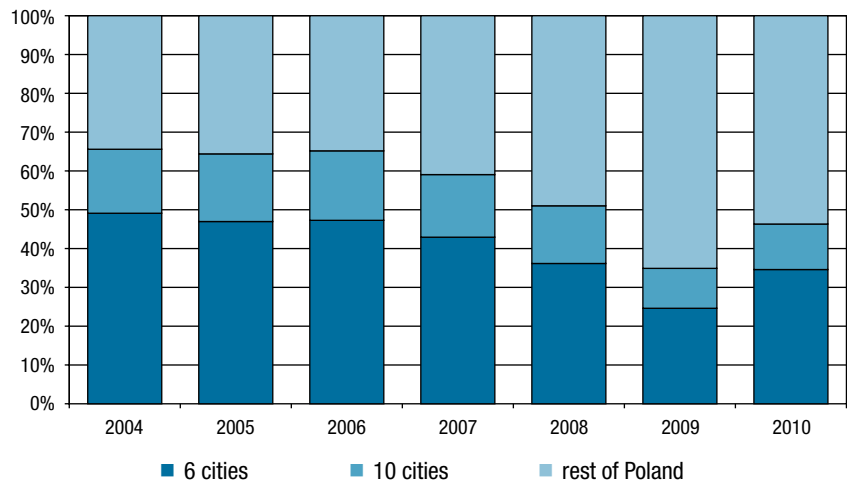


Source: own calculations based on data from GUS

of a public stock, after 2000 the credit expansion (Figure 9) as well as rapidly growing residential real estate prices, especially in major cities, was of critical importance (Figure 10). This had a significant effect on the size of the housing sector, especially on the relationship to the rest of the economy. As a result, the share of housing assets, especially assets in the largest cities, in relation to GDP significantly increased (Figure 11). Growing housing assets had in turn the effect of increasing consumer spending through the wealth effect. As a consequence of a rapid growth of prices, the size of the housing development in those cities increased, however their total impact on GDP as a part of total demand, measured by the share of housing investments, despite the increase, remained at a relatively low level; below 3%, and half of that figure was attributed to development investments in large cities. (Figure 12). Price increases were driven by the largest cities where the credit expansion and speculation based on expectations of further price increases were combined with fundamental factors such as an increasing number of marriages, rising incomes, and accelerated migration to cities. An important role in the spread of high prices, especially into the areas of small and medium-sized cities, was played by expectations related to the situation in major markets. However, they were based on very fragile premises – as a consequence a price adjustment occurred very fast in those markets.

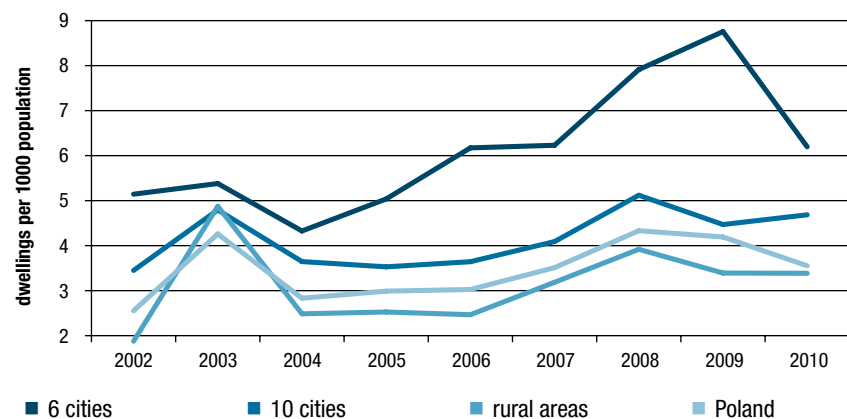
The surge in prices in major cities coupled with the growth of the development construction financed by bank loans were reflected in rapidly growing portfolios of mortgage loans in the banking sector. Their share, which was insignificant at the beginning of the decade, reached the level of over 20% of assets and over 250% of regulatory capital at the end of the decade, becoming an important factor affecting the stability of the financial sector (Figure 13). The structure of granted loans also changed dangerously. The entire decade was dominated by foreign denominated loans, financed directly from capital markets, or by parent banks of Polish companies. As a result, their share in the portfolio as a whole reached 60% (National Bank of Poland, NBP, statistics). Rising housing prices and more accessible loans caused an increase in the indebtedness of households and, consequently, an increase in the share of housing loan repayments in their budgets, despite the increase in household income. However, their average share did not exceed 20%. Expenses related to flat maintenance also increased, however their growth was slower than income growth, which resulted in a slight decrease in their

**Figure 6 Spatial Structure of New Housing Loans**



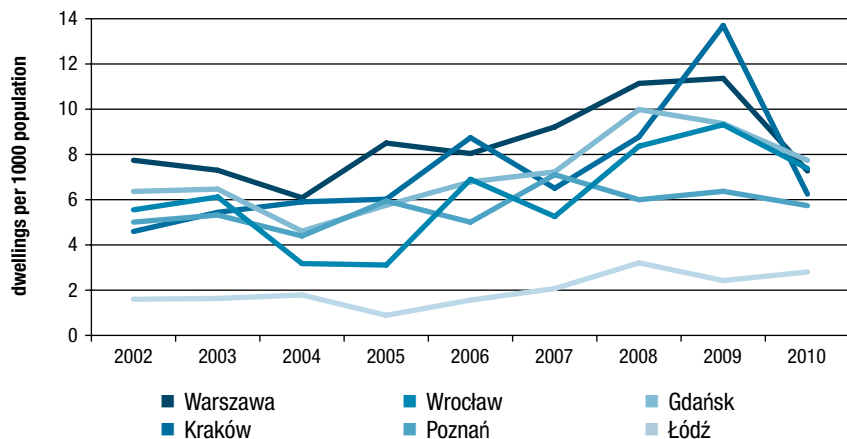
Source: own calculations based on data from Biuro Informacji Kredytowej – BIK(credit bureau)

**Figure 7 Dwellings Completed per 1000 Population**



Source: own calculations based on data from GUS

**Figure 8 Dwellings Completed per 1000 Population in 6 Biggest Cities**



Source: own calculations based on data from GUS



share to around 20%. Consequently, flat housing<sup>1</sup> expenditure of households repaying loans reached the level of approximately 40%, thus becoming the main group of expenses. This factor will have a future impact on the quality of mortgage loan portfolios.

The housing situation in Poland, although significantly worse than the EU average (Figure 14) is adequate to the level of development measured by GDP per capita. The situation is relatively the best in the largest cities, which saw a significant improvement in standards in the last decade.

A relatively low GDP and housing standards result in a high marginal utility of housing consumption, which translates into a high flexibility of housing demand in relation to the growth of the purchasing power. As a result, the demand for housing loans increases along with the increased availability of loans (Figure 15) and housing demand increases along with the increased availability of housing units. (Figure 16).

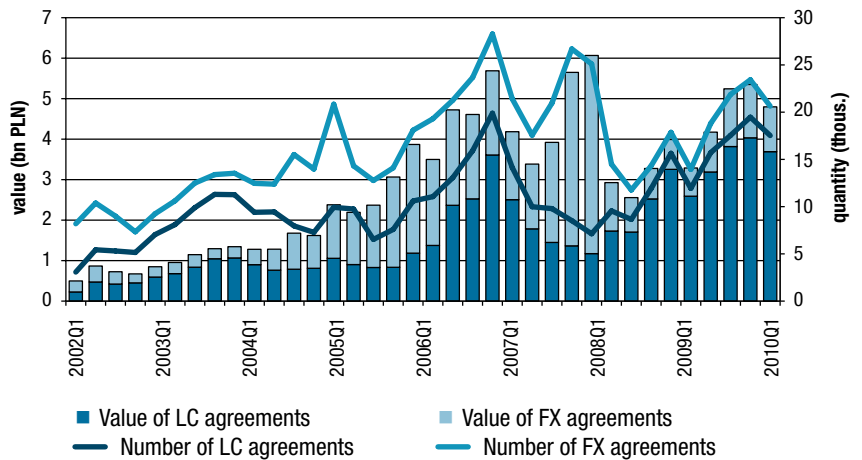
## 2. Cycles in the housing market in Poland between 2005 and 2008

The primary factors triggering the boom and in the subsequent stage the speculation and price bubbles in the markets of the largest Polish cities between 2005 and 2007 comprised the increasing availability of loans to households, coupled with the excess liquidity of banks and their lack of aversion to finance the sector. They resulted from such phenomena as the progressive stabilisation of the economy – a decline in inflation and increase of income, accession to the EU, and increased optimism within society as well as excess financial liquidity and booms in housing markets of many countries. Loans denominated in Swiss francs are of a particular importance as they triggered and drove the entire process, similarly to sub-prime loans in USA or other higher risk credit facilities that occur frequently in similar situations. In parallel, fundamental factors also had their influence, i.e. demographic factors such as migration, growth of new households and income growth.

Loans denominated in Swiss francs with a lower interest rate and a dangerous exchange rate risk borne by the borrower were much more accessible to households due to the disparity

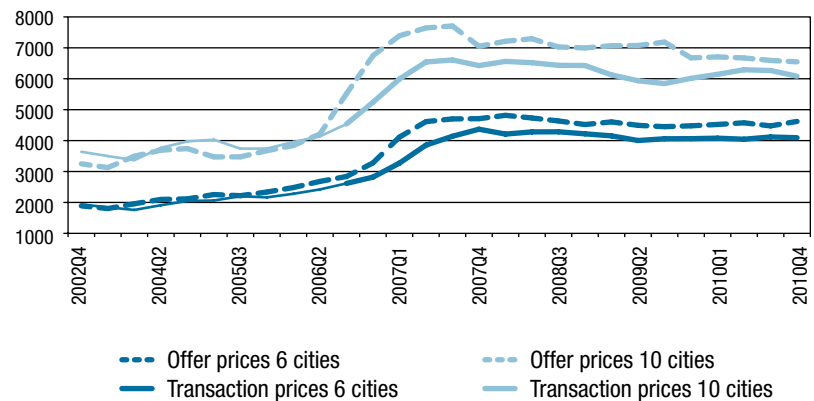
<sup>1</sup> Housing expenditure – goods and services purchased for maintains, repairs, modernizations, without electricity and fuels. Central Statistical Office, whose data we are using to calculate this position, takes representative basket of condominium fees, cooperative fees and expenditures of owner-owned single family houses.

**Figure 9 Credit Agreements 2002-2010**



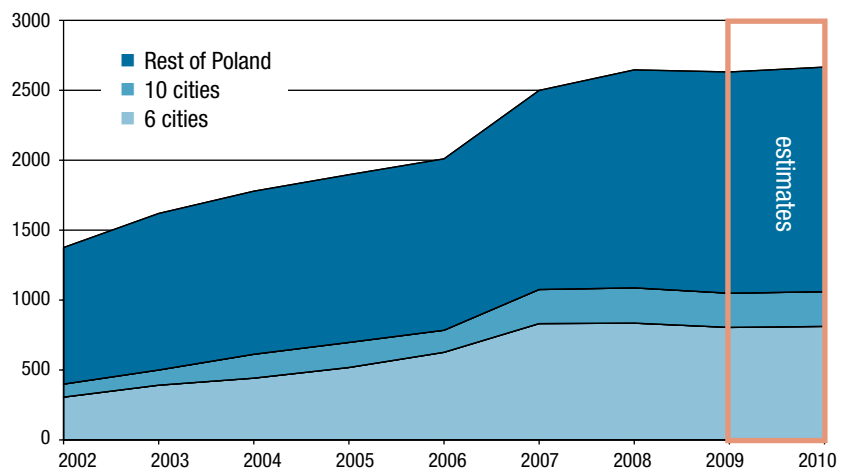
Source: own calculations based on data from the Polish Bank Association – ZBP

**Figure 10 Housing Prices in the Secondary Market**



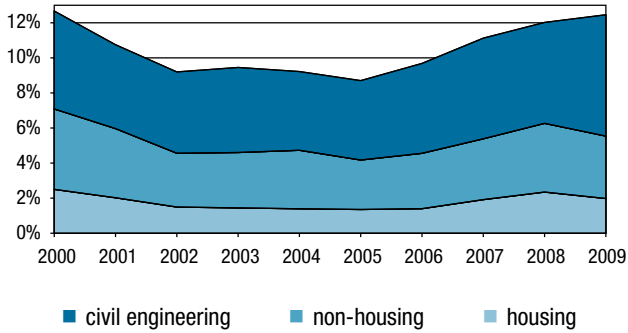
Source: own calculations based on data from PONT Info and NBP

**Figure 11 Residential Property in Poland (bn PLN)**



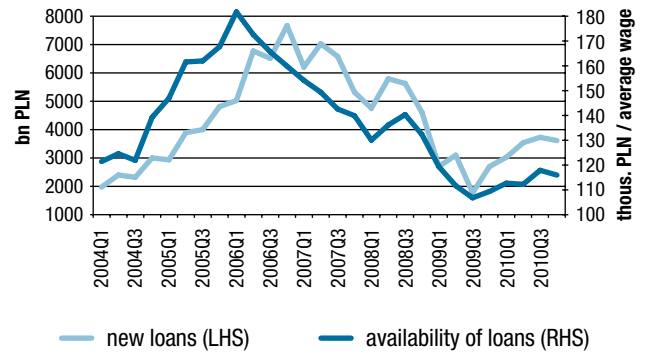
Source: own calculations based on data from GUS, PONT Info, Sekocenbud, NBP

**Figure 12 Construction Outlays (%GDP)**



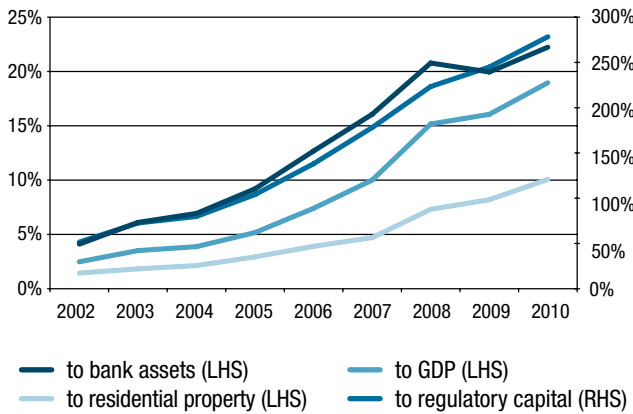
Source: own calculations based on data from GUS, PONT Info, Sekocenbud, NBP

**Figure 15 Availability of Loans and New Loans in 6 Cities**



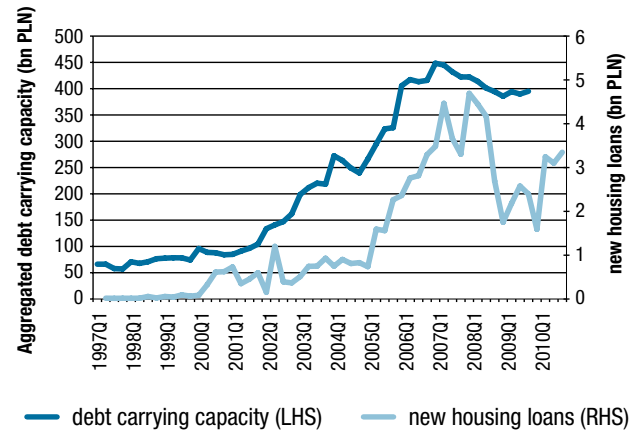
Source: own calculations based on data from GUS and NBP

**Figure 13 Housing Loans in Relation to**



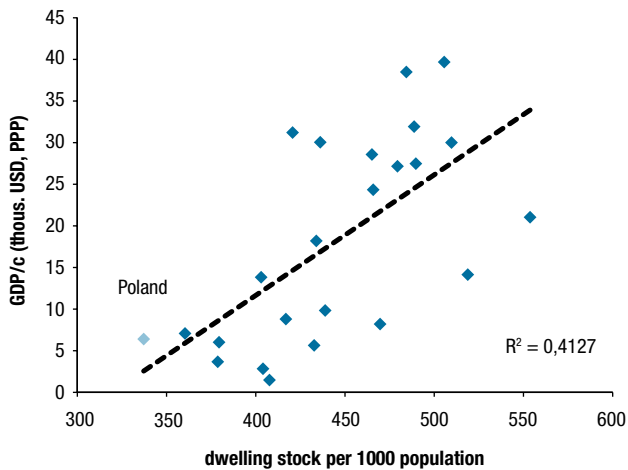
Source: own calculations based on data from GUS, PONT Info, Sekocenbud, NBP

**Figure 16 Aggregated Households Debt Carrying Capacity and New Loans**



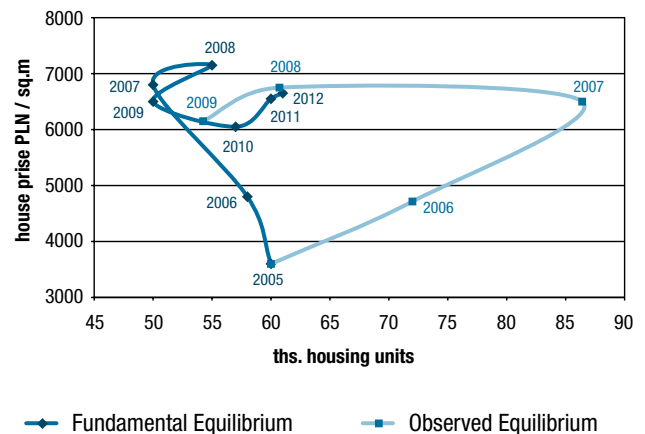
Source: own calculations based on data from GUS and NBP

**Figure 14 GDP per Capita vs Dwelling Stock per 1000 population (year 2005)**



Source: own calculations based on data from Hypostat and Eurostat

**Figure 17 Primary Market Equilibrium Path (7 cities)**



Source: own calculations based on data from GUS and NBP

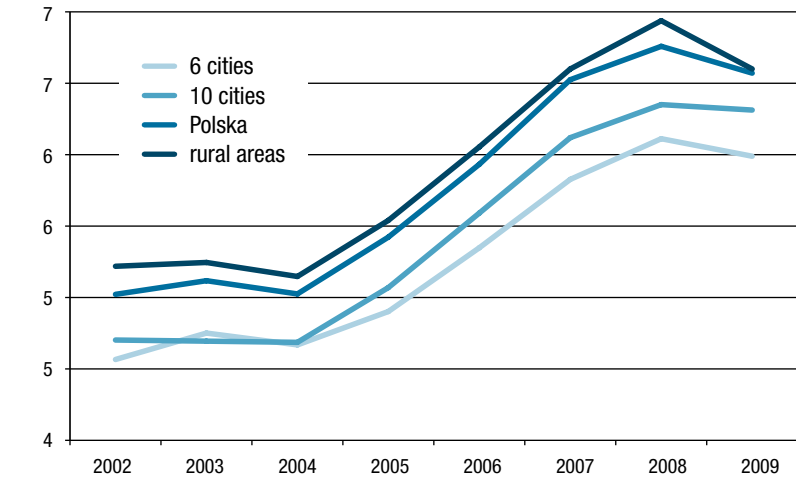
in interest rates. In addition to the higher availability – the effect of interest rate disparity, they were – ignoring the problem of the risk – more profitable for the banking sector, despite higher capital requirements. This was the result of higher margins and income realised on foreign exchange operations. They generated profits associated with the currency conversion, which frequently impacted on the incentive systems of the sales divisions within banks. The central bank's monetary policy not only failed to have an influence on them, but it triggered mechanisms giving rise to consequences opposite to those intended – the strengthening of the policy and interest rate increases instead of limiting lending and demand, resulted mainly in substitution effects in the housing sector, i.e. an increased demand for foreign denominated loans. As a result, the lending based on these instruments increased the demand in the housing market and short-term profits for the banking sector. A liberalisation of banks' lending policies, which widened the group of customers to include lower income groups and those with less stable incomes. It also allowed higher loan servicing costs for customers and was of great significance in the emergence of the credit boom.

The discussed factors played the role of the boom catalyst and they explain the first stage of the cycle, while the prime mover of the next stage was collective behaviour, including in particular the expectations of further price increases and related speculation. Figure 17 presents results of the analysis of short-term market equilibrium for the aggregated markets of 6 largest Polish cities estimated on the basis of the expert equilibrium model. Actual observed selling prices of housing units were applied to the results of the theoretical market equilibrium path.

The Figure 17 clearly shows that the fundamental volume of sales of contracts for the housing unit construction at the observed prices should be between 50-60 thousand units, while the actual sales volumes in 2007 exceeded 85,000 contracts, largely contracts with a high risk due to a very early stage of the investment. Basically people were paying in advance before the building was constructed (in normal times people were buying flats in already constructed, but not fully completed buildings; during the boom phase people were paying for the flats while the plot for the building was still empty).

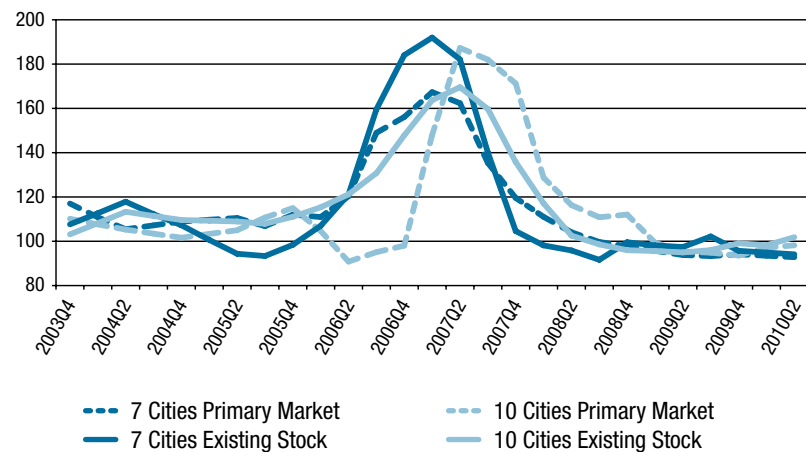
The mechanism of the cycle proceeded highly predictably, especially in the largest market in Warsaw, and in 6 major cities which were used for the analysis of the cycle. In various

**Figure 18 Marriages per 1000 Population**



Source: own calculations based on data from GUS

**Figure 19 Offered House Prices, Primary Market and Existing Stock**



Source: own calculations based on data from NBP and Pont Info

cities the patterns of the cycle showed some differences, particularly in respect of the price growth and level, the scale of tensions in the market measured by the ratio of market housing unit prices to household income or the length of each phase of the cycle. While during the boom the mechanisms were very similar, in the adjustment phase there were some differences between the markets. These resulted from the local nature of the major influencing factors. Higher income, lower interest rates and margins and the liberalisation of banks' prudential requirements translated directly into the availability of loans and demand for loans. As a result, loan balances quickly began

to grow in the banking system, which translated directly into housing demand. Important elements in the growth in demand for housing were demographic factors, in particular the increase in the number new marriages, and migration to the largest cities stimulated by the economic prosperity. (See Figure 18)

The fastest increases in prices were observed in the largest cities, and then they moved to markets in smaller provincial cities, and subsequently to the remaining markets. The original price impetus came from the secondary market and then moved into the primary market. The largest delay was recorded for construction costs

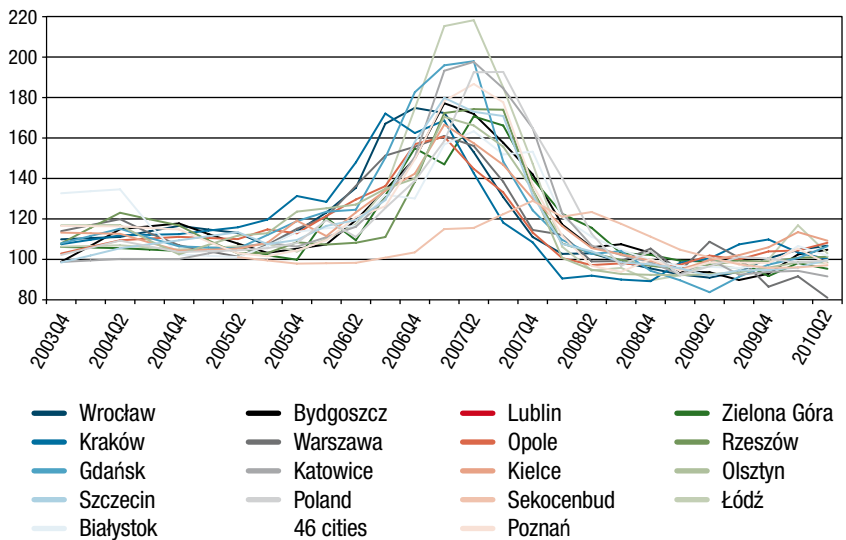
due to strong competition in the construction industry (Figures 19, 20).

In the first phase of the cycle, which took place in 2004-2006, the growing availability of loans resulted in an increase in loan disbursements and consequently in increased housing demand, which, combined with rigidity of supply, led to the rise in housing unit prices (Figure 21). Rising household income and falling interest rates resulted, however, in the fact that despite the increase in prices of housing units, their credit availability defined as the number of square metres financeable with available loans showed an increase. Consequently, the cost of ownership ratio, which is the inverse of the housing loan affordability ratio, showed a decrease, which meant that costs of loan servicing for the household for the purchased housing unit fell in absolute terms as a result of falling interest rates, and subsequently in relative terms due to the growth of income. The decrease in the costs of home ownership resulted in a further increase in housing demand, which, given tight supply, caused a further increase in housing unit prices.

In the second quarter of 2006 the opportunities for further increases in loan availability were exhausted and it began to fall. However, despite the declining availability of credit, demand continued to increase, fuelled by expectations of further price increases and associated speculative purchases. In the same period, demand in the housing market ran into an inelastic part of the supply (Figure 22), which resulted in the acceleration of price increases. At this stage mainly contracts for the construction of housing units at very early stages of construction were sold, and nonetheless the demand exceeded supply. Buying fever in the housing market resulted in behaviours on the development market that were well-known in other countries. To expedite project implementation and realisation of related profits, some developers elected to purchase already ongoing projects and land prepared for development and to finance those transactions with loans.

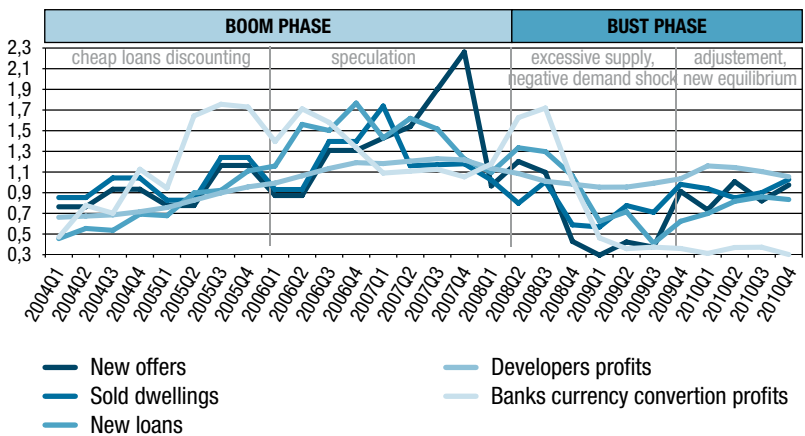
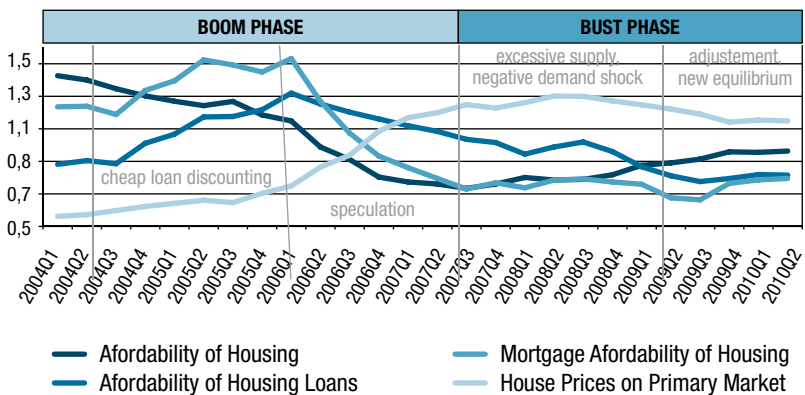
Rising loan disbursements accompanied by a declining credit capacity in late 2006 and early 2007 meant, from a macroeconomic point of view, that the banking sector gave in to the temptation of quick profits and got involved in the speculative game by granting more loans on the basis of the increasing collateral value rather than on the basis of the creditworthiness. A growing number of newly signed loan agreements and disbursed loans caused a rapid increase in profits of the banking sector, including profits from currency

**Figure 20 Existing Stock House Prices Y/Y Growth**



Source: own calculations based on data from NBP and Sekocenbud

**Figure 21 Cycle Mechanism – Warsaw (all variables shown as deviations from their 2004-2010 average)**



Source: own calculations based on data from NBP, GUS, REAS, BIK and Pont Info

conversion of loans (Figure 23). Rising profits translated into bonuses for employees, especially in sales departments, creating further pressure on sales. An important element of that pressure and the creation of the atmosphere for further increases in house prices were companies intermediating in the sale of loans and directly dependent on the size of their sales. These companies, selling usually loans of many banks, created a pressure for a further reduction in margin and liberalisation of requirements.

In 2007, supply began to be more flexible due to the passage of time necessary for the preparation of investment projects so that they could be placed on the market. High demand also caused an increase in price expectations of construction companies and manufacturers of building materials – consequently, prices of the construction and assembly production and construction materials began to rise. Rising housing unit prices coupled with increased supply meant that the markets began to accumulate a stock of unsold housing units. (See Figure 22)

In 2008 the existing trends reversed due to the violation of the law of money circulation in this market, i.e. balance dependencies between the increase in the number and value of contracts for the construction of housing units and the growth of money, i.e. loans to finance them. Although prices between 2007 and 2008 did not increase as much as in previous years, an additional supply from new investment projects occurred on the market. It exceeded by 50-80% its previous size, while the supply of loans between 2007 and 2008 practically stabilised as the banking sector began to experience problems related to the financial crisis, including barriers to liquidity. Consequently, the supply of unsold new housing units on the market of 6 largest cities increased between the first quarter of 2006 and 2008 from about 12,000 to more than 30 thousand to exceed 38,000 in the third quarter (Source: REAS Consulting Research). In 2008, as a consequence of the intensifying impact of the financial crisis, banks started to ration loans, whose supply fell much stronger than creditworthiness. The creditworthiness was declined in 2006 and 2007, but in 2008 it was already stable. This situation, due to a further increase in unrealised supply, caused pressure on the prices of contracts for the construction of housing units, which began to slightly fall. However, prices proved to be quite rigid and the mechanism of market adjustments began to work through the supply constraints. As a result, developers froze existing projects and

suspended new ones, waiting for the return of the boom. (See Figure 23).

Developers' actions brought limited results because a negative demand shock occurred in parallel as a result of a further reduction in lending by banks and expectations of consumers, who began to put purchases on hold, hoping for further price drops.

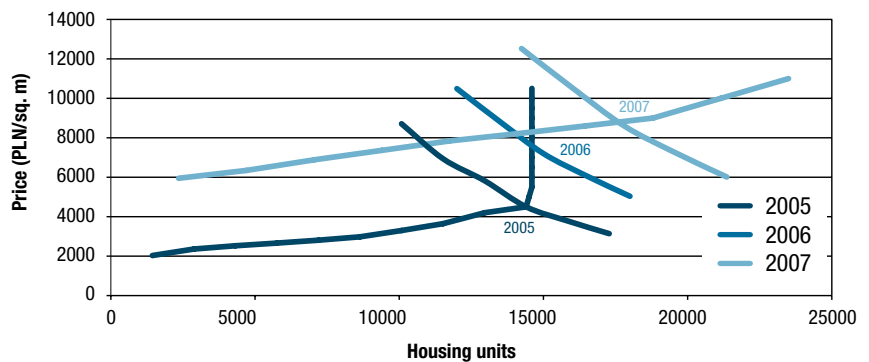
### 3. Basic development trends after 2008

The situation in the residential real estate sector in Poland after 2008 can be described as a process of further adjustments after the demand shock which followed the credit boom of 2005-2007.

This process concerns mainly markets in the largest cities being the main development markets and major credit markets, particularly in the area of traditional mortgage loans. A substantial increase in housing unit prices was recorded in virtually all of these markets and in some of them (Warsaw, Kraków, Wrocław) speculative bubbles occurred. The main consequence of these phenomena, in addition to adjustment processes in the housing market, was a decline in the quality of housing portfolios caused by liberalisation of credit requirements, which are currently coupled with materialised foreign exchange risk and the risk of declining collateral value.

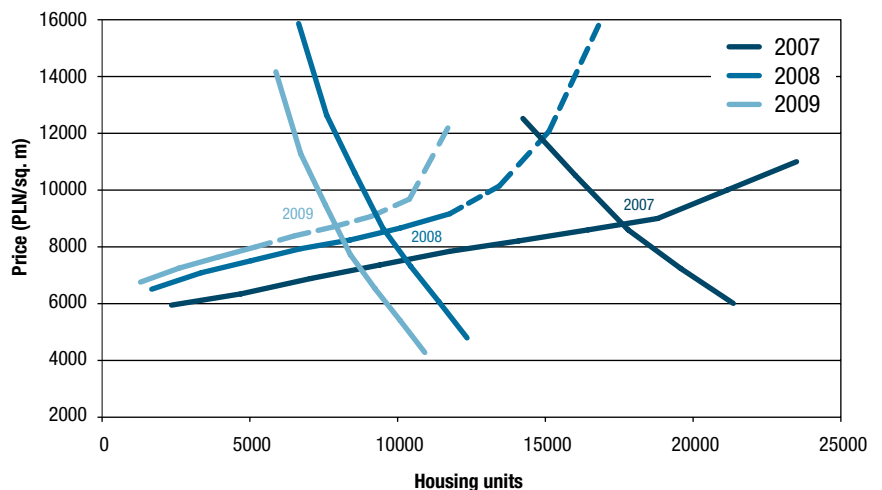
The discussed process of adjustments in the housing market thus includes both the pursuit of a new long-term equilibrium point based on fundamental factors, as well as short-term

**Figure 22 Warsaw Housing Market in 2005-2007 (expansion phase)**



Source: own calculations based on data from NBP, GUS, REAS and Pont Info

**Figure 23 Warsaw Housing Market in 2007-2009 (compression phase)**



Source: own calculations based on data from NBP, GUS, REAS and Pont Info

adjustments related to imperfections of this market and the economic policy.

In the markets of small and medium-sized towns dominated by private construction implemented under the economy system, the impact of these phenomena was only medium. These markets, despite a significant, i.e. 50% share in the volume of housing development implemented and loans disbursed, are not speculative - disbursed, small loans supplement the buyers' own contribution. They are very slightly liquid, and prices on these markets have no material impact on the size of the construction and the quality of portfolios. Factors that are essential in this respect are prices of construction materials and income growth in the economy.

In the markets of the largest cities internal mechanisms of the cycles coincided with the impact of the financial crisis, which flattened its course. The financial crisis strongly influenced the supply of housing loans and the overall economic situation and expectations, and it triggered delayed supervisory activities in the banking system. An increase in interest rates on housing loans resulting from a change in their structure, namely a significant decrease in the share of denominated loans was an important and probably permanent change in the fundamental factors. Consequently, the availability of loans, which is a measure of housing demand, fell by about 25%. In addition to accessibility problems, rationing of loans by banks also turned out to be significant. In 2010, the credit supply increased but it still was significantly lower than in the peak years of 2007 and 2008. In addition, some fundamental factors (migration to the largest cities, growth of income, increase in new marriages) turned out to be pro-cyclical or short-term.

In response to the decline in demand, prices became rigid and in some markets they slightly fell. Developers in most markets limited the volume of production and reduced new investments. Rigid prices in the development markets were a consequence of developers of good standing building housing units with the advances of future customers and therefore not being subject to the pressure of financial institutions, as well as a high, for this industry, concentration of production. In addition, the traditional financial buffer for development companies is the possibility of financing with commitments of construction companies. The government programme, "Family's Own Home", which accepted very high housing unit prices allowing the financing with loans subsidised by the government was also of material importance. In 2010, banks participating in the programme provided 43.1 thousand loans amounting to PLN 8.1 billion, i.e. nearly

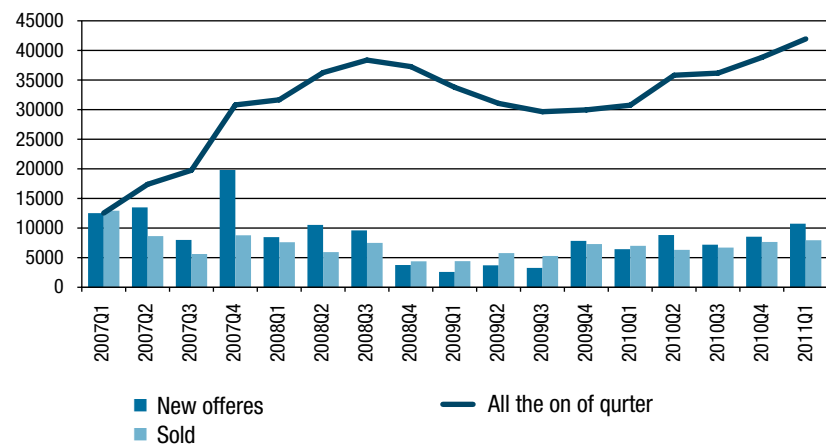
1.5 times more than in 2009; since the launch of the programme in January 2007 the total number of loans granted was 84.6 thousand loans worth PLN 14.8 billion.

Due to high housing unit prices and related profit margins as well as the high profitability of development production, from the fourth quarter of 2009 new developers emerged on the market, owing to a decrease in construction costs and easy access to construction land. This decline was significant enough for the share of profit in the price of the housing

unit in some markets to begin to grow again. New projects were also started by some large companies. An increased supply accompanied by limited demand resulted in another increase in the number of unsold contracts for the construction of housing units. It should, however, be kept in mind that throughout this period housing unit prices fell in real terms, causing a decrease in tensions on the market.

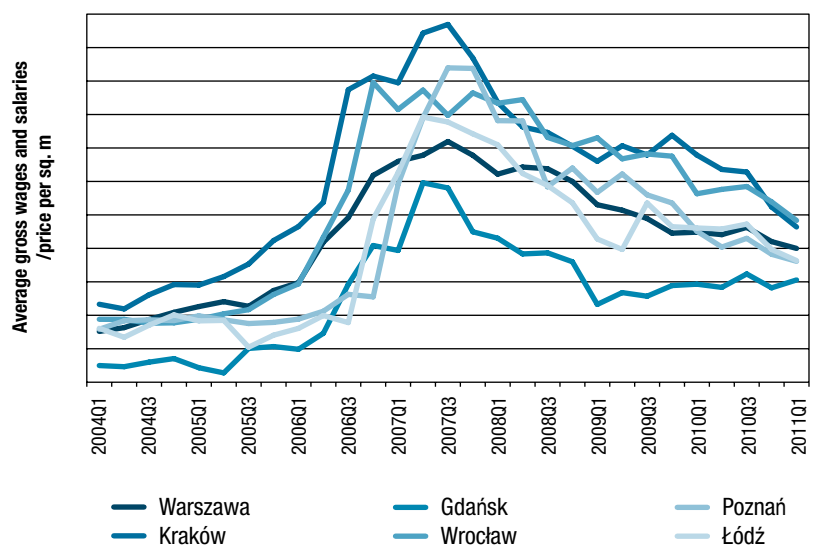
These processes were continued in 2010 and in the first quarter of 2011. The increasing supply pressure caused slight, nominal declines in

**Figure 24 Housing Transactions (new offers, sold, waiting for a buyer) in 6 Cities**



Source: own calculations based on data from REAS

**Figure 25 Average Dwelling Price vs. Average Gross Wages and Salaries**

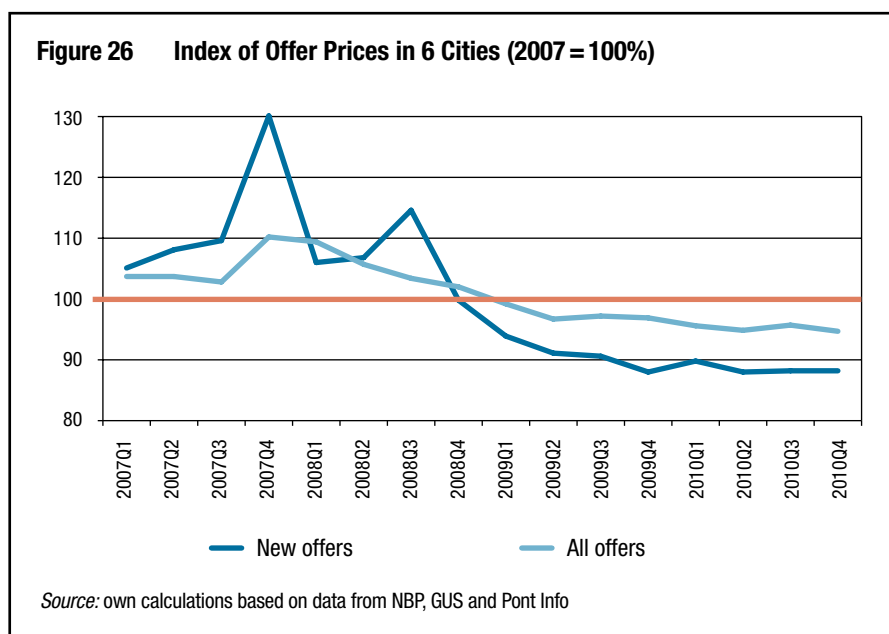


Source: own calculations based on data from NBP, GUS and Pont Info

prices of contracts for the construction of housing units in the largest cities and in prices on the secondary market (Figure 24). As a result, tensions on the largest markets continue to decline (Figure 25). Developers also realigned their price expectations, which is clearly visible in the index of contracts for the housing unit construction listed for the first time (Figure 26). New housing units are also smaller and cheaper and therefore better suited to the market situation.

The discussed factors determine to a large extent the situation in the sector over the next few months. Therefore, a further increase in supply should be expected, which, given the limited size of demand will result in a pressure on reductions of house prices. However, given the good situation of housing development companies, and in particular their low levels of debt in the financial sector and a high profitability of housing projects, the risk of forced sales which could lead to a sudden drop in the nominal value of collateral can be assessed as very low.

In the longer term the situation in the sector and the associated risk is much more complex. The residential market, especially in terms of deregulation of the financial sector is particularly vulnerable to speculation. A relatively safe development of this sector in the EU countries in the post-war period was a result of strong regulation, especially of the financial sector. In these conditions, major slumps were generally the result of obvious errors in the economic policy. Deregulation of the financial sector and its global nature makes a housing unit to be increasingly seen like an investment rather than a consumer good, as it is treated by the housing policy. The Polish real estate market has not undergone a serious slump so far which



along with substantial economic losses is in the long run a factor limiting the risk of speculation assumed by the financial sector. At the same time, the share of housing loans in the banking sector assets begins to be significant in terms of its stability, especially when associated problems will accumulate with other economic problems.

The analysis of well-known real estate crises shows that there are two major risks for Poland. The first one is related to the existing portfolio of denominated loans which generate exchange rate risk and liquidity risk for the banking system. The second one is associated with a rapid growth in demand which, with a rigid short-term supply, will trigger the mechanism of price increases driven by expectations of their further growth and financed with loans. Such a

risk is associated particularly with the scenario of external capital inflow and financing from this source of denominated loans, i.e. a repetition of the boom. Factors favouring the emergence of imbalances may include a faster economic growth, triggering again fundamental factors, such as migration to urban areas, increase in income and optimism and a housing policy increasing the availability of housing units. However, in the coming months the probability of such a scenario does not seem high. Liberal monetary policy in the U.S. and the EU causes indeed a high liquidity in the financial markets, but it is unlikely that another credit boom based on denominated instruments does not meet with restrictions of financial supervision. Similarly, the scale of public sector debt makes the scenario of massive housing subsidies unlikely.

# Mobilising Pension Assets for Housing Finance Needs in Africa – Experiences and Prospects in East Africa<sup>1</sup>

↳ By James Mutero

## 1. Introduction

Pension funds are hugely attractive to providers of housing finance as they typically represent a large pool of domestic savings and generally consist of long-term liabilities. But the trustees and managers of these funds, especially those in the private sector, are not so sure: they tend to be conservative in their approach to fund investment to shield member assets from loss. Although the recent turmoil in the global financial markets has not been a major issue in some of the housing markets of the South it has nonetheless created additional anxiety about the security of housing investments. Further, in many jurisdictions, there are regulatory constraints to pension funds investing in the housing sector. All the same, trustees are increasingly aware of the need to continue seeking profitable investment opportunities in new areas that often include property in general, and housing in particular. Opportunities also exist for pension schemes to issue debt, on the strength of their balance sheets, and in this way to mobilize capital to finance housing for their members.

This paper uses the results of surveys in the four East African countries of Kenya, Tanzania, Rwanda and Uganda, as well as secondary material, to assess the potential of using pension funds to finance housing, especially for lower income groups. In varying degrees, all four countries face severe housing shortages most notably in their urban centres where shelter conditions are dire as a result of high urban growth rates,

low-incomes for the vast majority of households and weak housing markets. These markets lack the capacity and capital to expand the supply of affordable housing and to provide appropriate housing finance products.

The paper is organized as follows: Section 2 gives an overview of the economic and financial setting in the four countries, highlighting the implications for pension fund investments; Section 3 describes pension schemes and their coverage; Section 4 looks at regulation, the investment opportunities open to pension schemes, and the consequent pension fund behaviour; Section 5 turns to the mobilization of pension assets to meet housing needs whilst Section 6 draws out the main findings and sets out the key recommendations.

## 2. Economic and Financial Setting

Although the four jurisdictions are classified as low-income countries they show substantial diversity in their economic and financial characteristics. Kenya has the largest economy and most developed financial sector, broadening investment options for pension funds and thus raising the prospects for channelling resources into the housing industry: it has the highest market capitalization of listed companies as a percentage of Gross Domestic Product (31.6% in 2008), followed by Tanzania (6.3%) and Uganda (1.1% in 2005)<sup>2</sup>. Pension funds

in Tanzania, Uganda and Rwanda have more limited choices but the trend towards integrating capital markets in the region should widen investment opportunities.

Two economic features of these countries have important implications for utilizing pension funds for housing: the state of their capital markets; and the rapid informalisation of the respective economies, highlighted in Christiaan (2002) and Liimatainen (2000). The incipient capital markets limit avenues for investment, whilst informalisation works against workers seeking housing in three ways. First, with little exception, informal workers are not members of pension funds and, therefore, do not have access to the end-user finance offered by such funds. Second, pension investments in housing finance are usually routed through financial institutions that act as mortgage lenders. Yet these are the channels that typically exclude all but a small minority from accessing housing finance. Third, even where retirement benefit schemes invest directly in property development, informal workers often do not qualify for the housing on offer.

## 3. The Pension Landscape: Institutions and their Coverage

### 3.1 Institutions

Public retirement schemes hold the bulk of pension funds in Tanzania, Rwanda and Uganda but

<sup>1</sup> This article draws on a 2010 study commissioned by FinMark Trust of South Africa. The study was conducted by Matrix Development Consultants, Nairobi, Kenya (<http://www.matrix-africa.com>), in collaboration with Mwijage Bishota, Dr William Kalema (UMACIS Consulting) and Duncan Kayiira (UMACIS Consulting). Dr James Mutero, a Senior Associate at Matrix, led the study team. To access the report, visit <http://www.tinyurl.com/6ywwdq>

<sup>2</sup> World Bank (2009). Market capitalization in Rwanda is insignificant.



this dominance is less pronounced in Kenya where a large number of retirement schemes have been established by the private sector. As in the rest of the world, there has been a steady shift in Kenya from Defined Benefit (DB) to Defined Contribution (DC) schemes<sup>3</sup>. DC schemes also predominate in Uganda. Even though DC schemes, unlike DB schemes, transfer the investment risk to the member, their stance towards risk is not any less conservative because of the monitoring role played by members who take an active interest in the performance of their individual accounts<sup>4</sup>.

Kenya's pension assets amount to about 20% of GDP, the fourth highest such share in Africa after South Africa, Egypt and Mauritius<sup>5</sup>. The retirement benefits sector is composed of the civil service scheme, the National Social Security Fund (NSSF), private occupational schemes and individual pension schemes, with an overall coverage rate of around 15% of the workforce.<sup>6</sup>

There are five<sup>7</sup> public pension schemes on the Tanzania Mainland<sup>8</sup> and an additional pension scheme in Zanzibar, the Zanzibar Social Security Fund (ZSSF). But there are no private occupational schemes, unlike in the other countries, as liberalization of the pension industry is yet to start. The public schemes draw their membership from different occupational groups and generally permit full or partial withdrawal of accrued pension entitlements in the event of unemployment.

In Rwanda, the pension industry comprises one public pension fund the *Caisse Sociale du Rwanda* (CSR) and about 40 nascent private pension schemes. There are, however, no readily available statistics on the different private firms that operate in-house pension schemes.

Uganda's pension industry is limited both in coverage and scope, with less than 2% of the labour force covered by pension schemes. The industry is dominated by the National Social Security Fund (NSSF) and the Public Service Pension Scheme (PSPS). There are also a few private occupational schemes and unfunded public sector schemes.

### 3.2 Coverage and Profiles of Contributors

In all four countries, the vast majority of pension scheme members are formal sector workers. Pension coverage is roughly 15% in Kenya, 6.5% in Tanzania, 7.5% in Rwanda, and a mere 1.7% in Uganda<sup>9</sup>. Members of private pension schemes tend to have higher incomes than those in public schemes such as the public social security funds in Kenya, Tanzania and Uganda. Rwanda and Uganda provide good examples of the hurdles members of a public pension scheme would face if they sought to borrow from mortgage finance institutions in settings where pension-backed loans do not exist: in Rwanda, slightly above 72% of CSR members have salaries less than USD 180, not enough to qualify for a mortgage loan; and in Uganda, around 60% earn salaries less than USD 200 per month and nearly 85% less than USD 500, the minimum income typically required by banks to obtain mortgage finance<sup>10</sup>. These indicators provide compelling evidence of the limited scope of mortgage finance, even for formal workers, in countries where pension benefits are not employed to provide partial guarantees to improve access. Table 1 summarises the main features of pension funds in the four countries.

## 4. Regulation, Investment Opportunities and Pension Fund Behaviour

### 4.1 Regulation

The regulatory framework is most developed in Kenya where there is a formal regulator, the Retirement Benefits Authority (RBA). Formal regulation has created a uniform approach to influencing the behavior of the main players in the pension industry. An important requirement is for pension schemes to submit annual accounts to the RBA, investment returns every quarter and investment policies at least once every three years<sup>13</sup>. Besides seeking to ensure compliance with statutory requirements, the regulator has been able to publish information on a wide range of subjects: regulations on the governance of pension funds; investment guidelines; and portfolio performance. In addition, the regulator maintains and publishes a register of approved administrators, fund managers, and custodians. In the other countries there is no formal regulator and a uniform approach to regulation is therefore lacking as are published statistical aggregates.

**Table 1: Main features of pension funds**

	Kenya	Tanzania	Rwanda	Uganda
Pension assets/ GDP (%)	20	App. 7.5	1.6	4.2 <sup>11</sup>
Pension fund members	1.4 million <sup>12</sup>	App. 915,000	< 300,000	> 500,000
No. of funds	App. 1,500	6	App. 40	>100
Members as a % of working age population	App. 15	6.5	7.5	App. 1.7

<sup>3</sup> A defined benefit scheme is one that specifies the benefits a member will receive on retirement. The investment risk falls on the fund which commits to pay a certain benefit, usually a proportion of salary at retirement, regardless of the performance of the fund's investments. In a defined contribution scheme the members' contributions are set at a specific rate (usually a percentage of salary) and these are ring-fenced and invested – the member is able to assess the performance of his or her individual contributions. The investment risk rests with the member. Source Genesis (2009).

<sup>4</sup> Interviews with investment managers.

<sup>5</sup> Interview of Retirement Benefits Authority.

<sup>6</sup> Stewart, F. and Yermo, J. (2008).

<sup>7</sup> These are the National Social Security Fund (NSSF), the Local Authorities Pension Fund (LAPF), the Parastatal Pension Fund (PPF), the Public Service Pension Fund (PSPF) and the Government Employees Provident Fund (GEPPF).

<sup>8</sup> While the union between Tanzania Mainland and Zanzibar is referred to as the United Republic of Tanzania, each of the two geographic entities has its own pension schemes.

<sup>9</sup> Ratio of pension scheme members to the labour force. Figures based on secondary sources and survey estimates.

<sup>10</sup> Field interviews.

<sup>11</sup> Genesis (2009).

<sup>12</sup> Consists of 1 million NSSF members and 400,000 members of the civil service. NSSF membership includes about 350,000 members of occupational schemes.

<sup>13</sup> Mutuku, N. (2007).

Until recently, Kenya's RBA legislation did not allow pension schemes to use their funds to support pension-backed loans for housing nor to assign pension benefits for whatever purpose<sup>14</sup>. This blanket restriction has been lifted and the Retirement Benefits (Mortgage Loans) Regulations, gazetted in 2009, now permit the use of pension funds to guarantee housing loans taken out by members from an authorized lender. The guaranteed loans can be used for four purposes: acquiring a property outright; constructing a house; carrying out repairs, alterations and improvements; and financing down payments and closing costs – stamp duty, valuation and legal fees.

As none of the other three countries has a single regulator, each fund is regulated by its own board of trustees. In the circumstance, pension fund regulation and fund management practices differ across the different pension funds. Moreover, the lack of systematic regulation makes it difficult to maintain a coherent body of data and information on the pension industry. Our survey showed that steps are being taken to establish a single regulator in each of the three countries.

### 4.2 Investment Opportunities and Pension Fund Behaviour

The lack of adequately developed capital markets in the region has seriously narrowed the domestic investment channels available to pension funds. But cross-listing of securities among the exchanges in the four jurisdictions has started; a trend that is expected to broaden investment options.

Several factors influence the investment behaviour of pension schemes in the four countries:

- The state of development of the capital market;
- The investment guidelines of the regulator, where one exists, or of the board of trustees;
- Whether the scheme is in the public or private domain, as this determines the monitoring environment within which the scheme operates: monitoring is more stringent for private schemes, as trustees are individually liable; in public schemes regulation tends to be lax and politically driven;
- Age profile of members: pension schemes dominated by younger members are able to tolerate higher risks as payouts are in the distant future, whilst those with older members tend to be more conservative; and

- Anticipated staff turnover: schemes of firms with a low turnover have a smaller exposure to liquidity risk and can therefore invest in more illiquid assets, unlike firms with a higher turnover.

Because of their poor regulation and politically-driven investment decisions, public pension schemes have had a chequered investment record, failing to achieve the returns common to private schemes. At the Kenyan NSSF, Raichura (2008) notes that returns fall well short of those achieved by other retirement schemes, suppressing the expansion of membership. Field investigations revealed similar investment behaviour at the Ugandan NSSF. CSR in Rwanda appears to be the exception to the rule as its annual return, at 12.8%, is comparatively high.

The pricing of pension funds is an important part of the debate surrounding the use of pension funds for housing. In all four countries, these funds generally strive to obtain the best risk-adjusted return. As the purchase of risk-free government paper is often the best choice, it is an option that tends to crowd out the use of pension funds to support the housing sector.

## 5. Mobilising Pension Assets for Housing

To structure our review of how pension schemes in the region use their assets to finance housing, we follow Genesis (2009) who identify two general models:

- **End-user models:** These assist a pension fund member to obtain finance for the purchase or construction of a home; and
- **Investment models:** these provide a channel for pension funds to boost the supply of housing finance either through direct investment in housing development, or using debt and equity.

The end-user model has two variants: the first has the fund making direct loans to members whilst in the second the fund provides guarantees for members to take out loans from a third party. We have added a third variant, the debt issuer sub-model, since pension funds can use asset-backed securities and other debt instruments to mobilize capital to finance housing for their members. In this capacity, pension funds would be intervening, not as investors, but as

mobilisers of capital. Most of the literature and related debate appear to have given limited attention to this variant, although Chirchir (2006) makes reference to it, noting that "In South Africa, pension administrators raise housing finance through the capital markets by issuing pension-backed securities to enable members to acquire home ownership".

### 5.1 End-user Models

#### Direct Loans

We could not find examples of direct loans in Kenya, Tanzania and Rwanda, not surprisingly as the law does not allow such lending. In Uganda, we found evidence of a retirement benefit scheme that allows members to borrow to finance their housing. To qualify for a loan, a member must have saved for a minimum of 4 years and started house construction.

#### Loans Secured by Retirement Benefits

In Kenya, the Retirement Benefits (Mortgage Loans) Regulations, published in 2009, allow a retirement benefit scheme to assign up to 60% of a member's accumulated benefits towards guaranteeing a loan amount of the same value from an approved lender, including microfinance institutions. But there will be no movement of funds from the pension scheme to the lender. This guarantee scheme has been informed by a scheme in South Africa whose implementation has had mixed results as more than 30% of loans have been diverted into non-housing activities.<sup>15</sup>

In Tanzania, the Public Service Pension Fund can now arrange for members to take out guaranteed loans from Azania Bank in which the Fund owns shares. We could not find evidence of similar loan guarantees in Uganda and Rwanda.

Whilst it is too early to judge how pension secured loans will fare in the Kenyan market, interviews suggested that it will take time for trustees to understand how the regulations can be made operational without exposing funds to higher risk. An area of concern, given that trustees have extremely limited market knowledge of low income housing, is whether "carrying out repairs, alterations and improvements" will be interpreted to include incremental construction by low-income households. Our view, on the basis of interviews and the complexity of incremental building, is that trustees will not stretch the scope of their lending to include such

<sup>14</sup> Chirchir, S. K. (2006)

<sup>15</sup> Sing, L. (2009)

housing. Details on how the scheme will work have not been worked out but the change in the law has already generated substantial interest within the pension community. Indeed, one of the leading Kenyan mortgage lenders, Housing Finance (HF), has introduced a new mortgage product in collaboration with an insurance company that is one of its main shareholders. These two firms expect to enjoy business synergy as the insurance company will provide life cover to HF's mortgagors.

## **Pension Schemes as Issuers of Debt**

The Capital Markets Authority in Kenya points out that pension schemes should consider issuing asset-backed securities to raise the funds needed to finance housing for their members. Regulations for this type of capital mobilization already exist but schemes would need to amend their trust deeds to pave the way for capital raising. Regulations for asset-backed securities do not exist in the rest of the study countries.

## **5.2 Investment Models**

### **Direct Investments in Housing Development**

In all four countries, there are many examples of direct investments in housing, especially by the public pension schemes. In Kenya, for instance, the NSSF has directly financed a mix of up-market and middle income housing but it has now shifted away from the higher end of the market<sup>16</sup>. The Fund's stock of housing assets is valued at USD 58.7 million or 5.5% of the Fund's entire portfolio, made up of the outstanding principal on loans to home buyers<sup>17</sup>.

Interviews of private funds in Kenya revealed particular wariness towards lower-income housing mainly because trustees and their fund managers do not understand the workings of this market. In particular, investing in rental housing for low income households is taken to be risky as rent collection can be problematic and expensive.

When Kenyan investment data are disaggregated by the size of the pension fund, an interesting picture emerges: small schemes do not invest in property whilst this asset class accounts for 2.4% and 4.4% of total investment

by medium and large schemes, respectively<sup>18</sup>. Small schemes avoid exposure to property because they have limited funds. Equivalent data for the other study countries were not available but for most pension schemes, irrespective of size, there is a general aversion towards investment in property, and in housing in particular<sup>19</sup>.

### **Loans and Deposits by Pension Schemes**

Interviews suggested that retirement benefit schemes do not commonly lend to mortgage finance institutions or place long-term deposits with them. The Kenyan NSSF, however, recalled having placed a deposit with HF to support the latter's development of a housing project in Nairobi, the capital city. In Tanzania, NSSF and other pension funds have provided Azania Bank, the pioneer mortgage lender, with a revolving line of credit equivalent to USD 1.5 million. This credit has a four-year tenor that has enabled the bank to boost its mortgage portfolio.

In Uganda, several studies have noted that the lack of long-term funding within the banking system has been a major hindrance to the growth of the housing finance sector<sup>20</sup>. Yet, until recently, the Ugandan NSSF had been reluctant to place long term deposits (above 10 years) with banks, preferring to invest directly in property. In 2009, the Fund offered a loan facility to a local bank seeking to extend its mortgage lending. The total loan amount was equivalent to USD 7.3 million, with options of variable or fixed interest.

### **Purchase of Debt Issued by Housing Finance Institutions**

Private sector pension schemes have invested in corporate bonds issued by housing finance institutions. In Kenya, interviews indicated that pension schemes had purchased bonds issued by Shelter Afrique, a pan-African housing institution; and Barclays Bank had tapped the bond market to support its mortgage lending, attracting funding from some pension funds<sup>21</sup>. In Rwanda, CSR bought about 1% of a corporate bond issued by the Commercial Bank of Rwanda (BCR) thus supporting housing finance. BCR is the pioneer mortgage lender in the country and holds more than 40% of the total mortgage portfolio. In Uganda, it is estimated that

about 3% of a USD 14.7 million corporate bond issue by Housing Finance Bank was bought by private sector occupational schemes. The amount invested could have been higher but some schemes considered the bond tenor to be unfavourable, while others thought that the coupon was not competitive. Stanbic Bank had also issued bonds worth USD 13.2 million in which some pension schemes had invested.

### **Acquiring Equity in a Housing Finance Institution**

In the four countries, there are examples of retirement benefit schemes acquiring an equity stake in a mortgage lender. In Kenya, NSSF owns substantial equity in HF whilst in Tanzania the public pension funds are allowed to acquire equity in institutions that specialize in housing finance products or housing development. NSSF has a 40% stake in Azania Bank and two other funds own 35% and 14%, respectively. In Rwanda, CSR holds shares in 11 companies two of which, the Rwanda Housing Finance Bank (BHR) and Rwanda Development Bank (BRD), provide mortgage loans. CSR owns 30% and 3.3% stakes in BHR and BRD, respectively. The two banks hold about 10% of the total mortgage portfolio in the country. Beneficiaries are mainly middle and high income households. In Uganda, NSSF<sup>22</sup> and the Bank of Uganda Retirement Benefits Scheme are among the top ten shareholders of Stanbic Bank which has a share of about 14% of the mortgage portfolio in the country. NSSF has an equity stake of 55 and 11%, respectively, in Housing Finance Bank (HFB) and Development Finance Company of Uganda (DFCU) Bank. HFB holds over 50% and DFCU Bank about 12% of the entire mortgage portfolio<sup>23</sup>. These statistics point to the important role pension funds play in supporting mortgage lending.

### **Other Institutions**

Most of the private sector occupational schemes interviewed noted that investing in real estate was very risky, and required a significant amount of resources. Although the schemes were open to such investments, many are less than 15 years old and have not built up substantial portfolios to be able to invest in property. Two institutional vehicles, if established, would provide channels for attracting pension fund

<sup>16</sup> Interview with NSSF

<sup>17</sup> Interview with NSSF

<sup>18</sup> Small schemes have assets less than KES 100 million (USD 1.3 million), medium schemes over KES 100 million but less than KES 500 million (USD 6.6 million) and large schemes over KES 500 million.

<sup>19</sup> Field interviews.

<sup>20</sup> Kalema, W. and Kayiira, D. (2008)

<sup>21</sup> Reported by Capital Markets Authority.

<sup>22</sup> NSSF controls 80 per cent of the Uganda Stock Exchange

<sup>23</sup> Field interviews

investments in housing: Real Estate Investment Trusts (REITs) and mortgage liquidity facilities.

A REIT is a collective investment company that owns, manages and develops real properties<sup>24</sup>. Instead of investing in real estate development private schemes could buy equity in REITs, and thus avoid some of the direct risks of investing in property, such as construction and credit risks. In Kenya, unlike in the other countries, regulations

for REITs have already been prepared.

The main function of a mortgage liquidity facility is to act as an intermediary between primary mortgage lenders and the bond market, with the objective of providing long term funds on better terms than primary lenders might be able to obtain if acting alone. This type of facility is being established in Tanzania by the central bank and commercial banks in collaboration

with the World Bank; and in Uganda and Rwanda it is receiving active consideration. In Kenya, the Capital Markets Authority has not been keen to approve a similar facility.<sup>25</sup>

## 5.3 Summing up

Table 2 summarises the various direct and indirect channels used by pension funds to finance housing in the region.

**Table 2: Different models of mobilising pension assets for housing**

			Kenya	Tanzania	Rwanda	Uganda
End User Models	Direct access to funds via partial or full withdrawal which could in principle be used to finance housing	Permitted?	No	No	Yes	No
		Done?	No	No	Yes & No <sup>26</sup>	No
	Loan from fund to a member	Permitted?	No	No	Yes	Yes & No
		Done?	No	No	Yes & No	Yes & No
	Loans secured by retirement benefits	Permitted?	No	Yes	No	No
		Done?	No	In the pipeline	No	No
Issue of debt by a pension fund (e.g. through a bond) to mobilize capital to support housing finance for members	Permitted?	No	Yes but would require amendment of trust deed	No	No	
	Done?	No	No	No	No	
Investment Models	Invest in housing projects	Permitted?	Yes	Yes	Yes	Yes <sup>27</sup>
		Done?	Yes	Yes	Yes & No	Yes
	Invest in housing development companies	Permitted?	No	? <sup>28</sup>	No	No
		Done?	No	?	No	No
	Invest in equity of mortgage lenders	Permitted?	Yes	Yes	Yes	Yes
		Done?	Yes	Yes	Yes & No	Yes
	Purchase of debt instruments (e.g. bonds) of mortgage lenders (e.g. commercial banks) or financiers of housing developers (e.g. Shelter Afrique)	Permitted?	Yes	Yes	Yes	Yes
		Done?	Yes	Yes	Yes	Yes
	Invest in asset backed securities (ABS)	Permitted?	No legislation for ABS	Yes	No legislation for ABS	No legislation for ABS
		Done?	N/A	Not yet	N/A	N/A
Invest in Real Estate Investment Trusts	Permitted?	No legislation for REITs	Yes (once REITs established)	No legislation for REITs	No legislation for REITs	
	Done?	N/A	Not yet	N/A	N/A	

N/A: Not Applicable

<sup>24</sup> Source: [http://www.co-opbank.co.ke/public\\_site/webroot/cache/article/file/Real\\_Estate\\_Investment\\_Trust.pdf](http://www.co-opbank.co.ke/public_site/webroot/cache/article/file/Real_Estate_Investment_Trust.pdf)

<sup>25</sup> Discussion with Capital Markets Authority.

<sup>26</sup> Where Yes and No both appear, some funds permit and others do not.

<sup>27</sup> All private schemes permit investments in housing but only one has actually done so.

<sup>28</sup> Denotes the lack of information on whether or not this can be done.

## 6. Main Findings and Recommendations

### 6.1 Main Findings

Capital markets in the four countries are relatively underdeveloped and this has narrowed the investment options open to pension schemes, denying them the financial instruments that would otherwise meet their risk-return preferences. Moreover, the growing informalisation of the regional economies substantially reduces the reach of pension funds as informal sector workers have historically not been members. Notably, pension coverage is small, ranging from 15% of the labour force in Kenya to a mere 1.7% in Uganda. This seriously reduces the potential use of pension funds as housing finance for low-income housing. But the stock of pension fund assets is significant, especially in Kenya where it is equivalent to 20% of GDP; in the other countries pension assets are relatively small, accounting for only 1.6% of GDP in Rwanda. Besides these general conclusions, specific findings are as follows:

- The existence of a regulator has streamlined the management of the pension industry in Kenya, unbundling the functions of the different players, specifying their fiduciary responsibilities, and setting investment guidelines;
- In Rwanda and Uganda the public pension funds hold a vastly larger share of pension assets than private schemes but this dominance is less pronounced in Kenya. In Tanzania, unlike in the other countries, there are no private occupational schemes;
- Several factors influence the investment decisions of pension schemes: the guidelines of the regulator, where one exists, or of the board of trustees; whether the scheme is in the public or private domain; the age profile of members; and the anticipated staff turnover;
- Private occupational schemes generally prefer investments in commercial property over housing but, on the whole, consider investments in real estate risky as they are illiquid and require substantial capital;
- In all four countries pension schemes have used their assets to meet housing needs, employing a range of mechanisms which include supplying end-user finance and investing in housing finance in a variety of ways. But there is no evidence of schemes issuing debt instruments to finance housing;
- Both public and private pension schemes have invested directly in housing development.

However, trustees have limited understanding of housing markets and are especially wary of investing in low-income housing arguing that its risks might be difficult to manage;

- Kenya has recently issued regulations to govern pension-backed lending which will enable scheme members to take out housing loans from approved lenders.

### 6.2 Recommendations

A number of measures will be required to promote the use of pension assets to meet housing needs. For all countries, the informal sector should be mobilized to join pension schemes to enable its workers to qualify for housing finance products supported by pension assets. Second, the four countries should reduce information asymmetries within their residential construction and financing sectors through improved data collection and dissemination. As a result, pension funds would acquire a better understanding of housing markets and their risks and returns.

In Kenya, detailed procedures should be formulated to implement the recently introduced pension backed mortgage scheme. Moreover, the country ought to debate how the new scheme should be made operational, to reconsider the decision not to create a mortgage liquidity facility, and to bring into force the regulations governing REITs. As for the three other countries, it would be important to quickly establish a regulator for the pension industry and create REITs and mortgage liquidity facilities.

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# Integration of Residential Mortgage Markets of Turkey and European Union in Light of Recent Regulation in Turkey<sup>1</sup>

↪ By Belgin Akçay<sup>2</sup>

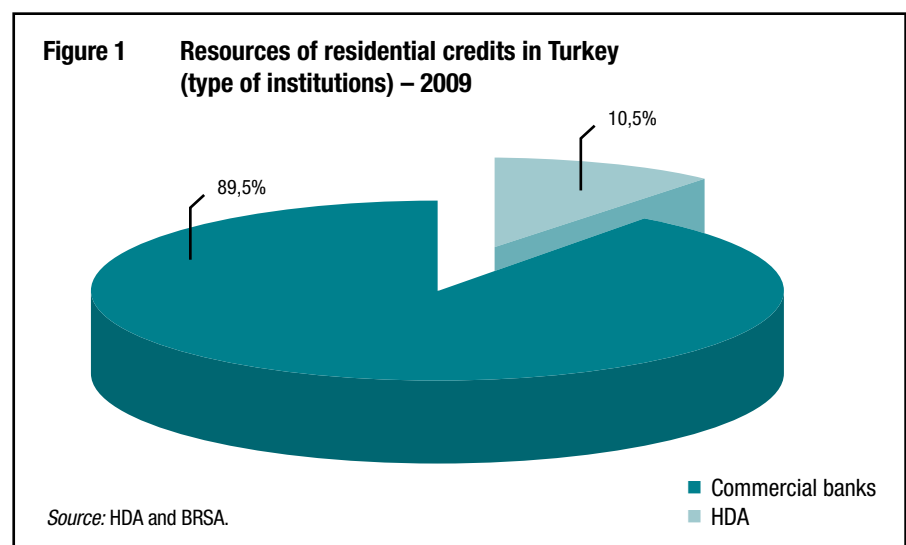
## 1. The Mortgage Markets in Turkey

### 1.1 Structure of Turkish Residential Mortgage Markets

In Turkey, for a long time, the public sector has financed those wanting to have a first home. Providing funds to homeowners was not attractive to the banking sector because the laws hindered supplying loans in this area until 1979. Later on, it had not been found appealing for the banking sector to give loans to home buyers compared to other investment areas despite the fact that legal handicaps had been eliminated. Beginning in 1989, it became more attractive to provide finance for housing, and starting with a couple of banks, this area has become one where all the banks operate and compete with each other. In addition, it has gradually become possible to provide financing for home buyers with lower interest rates and longer loan terms. Today, the Housing Development Administration (HDA), which has operated as a public institution since 1984, and commercial banks provide funds for people who want to buy housing in the Turkish residential markets.

Like the Turkish financial system, which commercial banks dominate (86.1%), they also dominate in the residential credit markets. As of the end of 2009, the share of commercial banks in the Turkish mortgage market was 89.5%, while the share of HDA was 10.5% (Figure 1).

The HDA has been acting both as a housing finance institution and as a real estate developer in residential mortgage markets. It provides loans for housing construction by cooperatives,



private companies, and municipalities. Real estate development activities of the HDA involve the consolidation of large tracts of land purchased from public or private owners and the preparation of plans, along with the provision of infrastructure. The HDA either implements large scale housing projects by contracting out both project preparation and construction or sells some of its project sites to non-profit home builders. The interest rates of HDA mortgage credits given to builders (cooperatives, private construction companies, and municipalities) have been indexed to the consumer price index (CPI) and the rate of state sector wage increases. The principal and interest rates are adjusted twice a year (January and July), while maturity changes between 5-11 years according to the size of housing.

Housing built directly by the HDA is sold at the beginning of the project. In general, these units

have a 18-to-24 month construction period and are sold with long financing terms, (i.e., 10 to 20 years with interest rates indexed to CPI and the rate of state sector wage increase). The principal and interest rates are also adjusted twice a year like other mortgage loans. Homebuyers make a down payment when they sign the purchase contract. The down payment is 15-25% of the sale price of housing. While a significant part of the HDA's revenues had consisted of special taxes on certain imported or domestically-produced goods and services, such as tobacco, alcoholic beverages and luxury goods consumed and used mainly by upper-income groups up to 1993, the activities the HDA came "on-budget" after 1992. Today, the revenues of the HDA come from government budgets and the selling of houses built by HDA. For the mortgage lending provided by the HDA, the annual interest rate was **8.1% in 2009**, while it was 8.4% in 2008 and 10.6% in 2007 (HDA, 2008).

<sup>1</sup> This article is the updated version of the paper presented in the 17<sup>th</sup> Annual AREUEA International Conference, July 4-8, 2008, Istanbul, Turkey, by benefiting from comments and suggestions made during the conference.

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The banking sector, in charge of the Turkish financial system, is writing loans secured by mortgages, with terms extending up to 20 years and with market interest rates, with the assistance of commercial banks. The interest rates of these loans could only be fixed rates until the new regulation came into effect in 2007. Nowadays, they can give mortgage loans with variable mortgage rates. The interest rates of loans given by the banks varied between about **12%-16%** in 2009, while they were between 9.5%-19% in 2007 depending on the loans' maturity. Deposits in the banking sector finance these loans.

Recently the volume of mortgage credit has been increasing. The share of mortgage credit of overall consumer credit and also of total credit has increased rapidly, particularly since 2004. Similarly, the ratio of mortgage debt to the GNP reached 4.1% in 2008, while it was only 0.2% in 2002 (Figure 2).

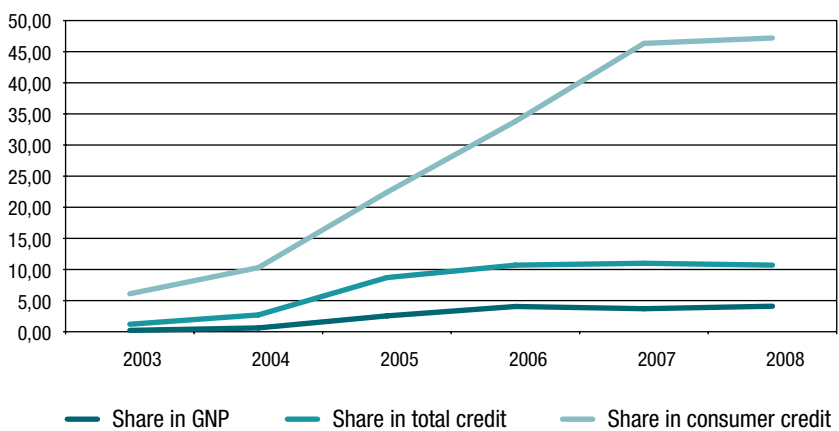
In Turkey, financial sources funding of mortgage credit stem from savings deposits collected by commercial banks and government budget transferred to the HDA. However, the provision of funds based on the market has not yet developed. In fact, although the necessary legal regulations exist for financing through mortgages, the provision of funds based on the capital markets has either stayed limited in relation to several practices, such as housing certificates (for houses in Halkalı-Istanbul built by the HDA in 1989), asset-backed securities (ABS) (issued by commercial banks giving mortgage loan during 1994-1996) and real estate certificates (for houses in Ataköy-Istanbul built by Emlak Bank, which was a state bank in 1995), or has never been applied such as a bond issue for HDA. Also, some implementations which can be important tools to decrease the risks in the supply of lenders, such as HDA's buying of the residential mortgage loans given by commercial banks like Ginnie Mae in the USA, have never been started in spite of the presence of the necessary legal infrastructure.

### 1.2 New Regulations in the Residential Mortgage Markets

New arrangements have been made concerning housing finance with "The Law Amending the Laws Related to the Housing Finance System," numbered 5582 and known as the "Mortgage Law" in public opinion. This legislation came into effect in February 2007. Preceding this law, the main problems in the financing of housing in Turkey were:

- Lack of an efficient system in the financing of housing (this is valid both for the lenders

**Figure 2 Trends in residential mortgage credit in Turkey (%) (by Commercial Banks)**



Source: BRSA, 2009.CBT, 2009.

and borrowers as well as for both the builders and buyers).

- Few institutions were supplying funding support to the housing sector (there are two types of institutions: HAD, -which is a public entity, and commercial banks)
- The high cost of the funds used in the financing of housing (financial resources supplying borrowed funds to housing outside the State are made up of a large amount of deposits. Only about 60% of the deposits collected can be used to give mortgage loans, because of the additional provision and reserve requirement ratio; this leads to the high cost of funds to be lent, and thus is reflected in the terms to the borrowers.)
- Inadequacy in meeting the funding needs of low- and middle-income groups. (In particular, although the terms (payment period) lengthened to 20 years after 2004, it has been possible for only high-income groups to benefit from the expensive credit or for the middle sector to have the power to pay if they have savings equal to 50-60% of the value of the house).
- Unavailability of sufficient and low-cost funds for builders.
- Lack of incentives such as interest deduction, tax deduction, or exemption in repaying the loan which encourages and facilitates house owning, as there are in countries with higher rates of home ownership.

As can be seen, preceding the new law coming into effect in 2007, there was a lack of an efficient system which allowed the middle- and

low-income home buyer to pay for a house in spite of low-interest rates and lengthening terms. There are no affordable conditions of the mortgage credit for allowing the middle-income group to be able to pay according to its financial situation.

As a result of the initiatives started in 2004, when the new law was put into effect, with the aim of solving most of the problems mentioned previously, the following objectives were established:

- Creating institutions for financing mortgages,
- Allowing mortgage financing institutions to accept residential mortgages to securitize the loans,
- Allowing new types of institutions (financial leasing companies, financial companies) to accept residential mortgages to securitize loans.

Then,

- Allowing commercial banks, which gave residential mortgage loans, to securitize these loans,
- Allowing public institutions, such as HDA which were giving residential mortgage loan, to securitize them,
- Providing the ability to securitize depending on a "cover pool",
- Ensuring the continuity of the new housing finance system with the "Housing Finance Fund and Asset Finance Fund".

Thus, it will be possible for consumers to obtain



funds from financial institutions outside of the usual banks by forming a bridge between the ones who are in need of funds; those who are the buyers of housing, and those who have surplus funds.

The system envisaged by the new law is based on obtaining resources through the issue of mortgage securities, providing long-term funds to the residential mortgage markets by the intermediation of commercial banks and newly-established mortgage corporations, and giving mortgage loans by using this resource. In order for this system to develop and strengthen, a lot of changes have been made in the articles of a number of laws – with the Consumer Protection Law, Capital Markets Law, Execution and Bankruptcy Law, Civil Law, and Tax Law receiving the main priorities.

Innovations the new mortgage law brings to the mortgage markets are:

- Changes made in the related articles of a number of laws to the advantage of those who want to borrow funds and to those who supply funds and, especially lenders.
- Establishing alternative institutions to meet the funding needs of the home buyers other than banks by allowing mortgage finance corporations and financial leasing companies into the mortgage markets.
- Allowing banks and the newly-established institutions participating in the market to offer mortgage credit with variable interest rates (previously only HDA could lend with adjustable rates).
- Creation of new funds based on resources provisioned from the capital markets
- In case a problem arises in paying back the credit, shortening the execution period in favour of the lenders.
- Abolishing the Banking Insurance and Transactions Tax (BITT) for mortgage credit, which is at a rate of 5%.
- Exempting mortgage transactions by the residential finance companies and mortgage companies from charges.

As a result in Turkey, even if it is a desirable thing, it is evident that establishing a mortgage finance system dependent on a market able to provide the ability “to buy a house just like paying rent” for the middle-income group with the new law put into effect recently, and having the desired results, will take a long time to happen. The reasons mentioned above take into consideration the depth of the capital markets and the extent of the potential of institutional and individual investors

which can supply funds and also the extent of the insurance markets. However, since the new regulation has been put into effect, there have not been any improvements, yet.

## 2. The Integration of European Union Residential Mortgage Markets

In the EU, the importance of residential mortgage debt has continuously increased because of the liberalization efforts made in the financial markets and decreasing interest rates over the last 10 years. It can be seen from the growing

volume of the residential mortgage debt that mortgage lending is a growing industry. As of the end of 1999, mortgage debt was 3.1 trillion Euros (EMF, 2000). It reached 6.1 trillion Euros by the end of 2009 (Table 1). Thus, mortgage debt to GDP in the EU-27 increased up to 51.9% in 2009 from 35.6% in 1999. Also, this level is higher than that of 2008 (49.9%). However, this growth is due to the sharp decline in GDP in 2009 (4.2%) as a result of the global financial crisis, which was triggered by the subprime mortgage crisis in the U.S.

This increase in the total mortgage debt reflects the credit dynamics strengthened by

**Table 1: Residential Mortgage Markets in the EU-2009**

Country	Value of Mortgage Debt (€ Million)	Residential Debt to GDP Ratio (%)
Austria	72.487	26.2%
Belgium	146.329	43.3%
Denmark	231.263	103.8%
France	737.600	0,4
Finland	71.860	0,6
Germany	1.146.969	47.6%
Greece	80.559	33.9%
Ireland	147.654	90.3%
Italy	330.585	21.7%
Luxembourg	15.842	0,4
Netherlands	602.192	105.6%
Portugal	110.685	0,7
Spain	678.872	64.6%
Sweden	236.062	0,8
UK	1.372.659	87.6%
<b>New Members</b>		
Bulgaria	4.268	12.6%
Czech Republic	16.975	19.4%
Estonia	6.111	44.5%
Hungary	15.543	16.7%
Latvia	6.866	36.6%
Lithuania	6.032	22.2%
Malta	2.458	0,4
Poland	56.569	18.2%
Romania	5.700	4.9%
Slovenia	3.972	11.4%
Slovakia	9.226	14.6%
South Cyprus	3	61.3%
<b>EU-27</b>	<b>6.125.727</b>	<b>51.9%</b>
Turkey	19.386	4.6%

Source: EMF (2010), *Hypostat 2009*, pp.79,82.

the declining interest rates in the Euro area, to a great extent, after the application of a single monetary policy (ECB, 2006). Mortgage rates have declined substantially over the past ten years and reached historically low levels in 2005. Since the end of 2005, although they started increasing again, due to several interest rate hikes by the ECB and other European central banks (EMF, 2008), the interest rates have decreased as a result of the global financial crisis, which started at the end of July 2007 (EMF, 2010).

Besides, with increasing financial liberalization, the increasing efficiency of some of the EU countries in the mortgage markets and a recovering competitive environment have all been effective in increasing the demand for housing. Today, it is known that EU retail financial markets and, as a result, mortgage markets have not integrated fully yet. As a matter of fact, in EU member countries, most consumers receive services from the national institutions in the retail markets, and the 'beyond the border' activities of the firms in these markets are sparse with the product range supplied being different to an important extent among the member countries. The differences between the mortgage markets of the EU member countries stem from the structural characteristics of the markets peculiar to these countries. These characteristics can be listed as follows (Wyman, 2003. EC, 2011a).

- The demand for housing depends on the countries' demographic characteristics and their national traditions. For example, the house-buying age in these countries is from the beginning of the 30s to the middle of the 40s. The ratio of this age group to the total population is a factor determining the demand for housing. Other factors affecting the demand for housing are the size of the household, the percentage of home ownership, the income level of the household and the loan-to-value (LTV) ratio. A high LTV ratio means higher credit. While in some countries, the structure of the family and transfers coming from the family for buying a house are effective in changing the demand for housing, in some countries, the presence of social housing stock at a high level decreases the ratio of owner occupation and the borrowing level of the household for the housing.
- The differences in the ratio of mortgage credit reflect the specific differences in the housing markets. For example, the cost of a house and the differences in a house's average price reflect the structural differences between mortgage markets. A house with a high price

makes it difficult for the household to save enough from the budget and requires a longer time to save a bigger amount. Besides, the price of the house and its cost is measured by the income per capita and the level of mortgage debt and also is related to the country's level of development.

- The differences in the household debt may be related to the country's financial structure and the easy access to the funds the household has. The foregoing factors affecting this are the broadness of the appropriate product range, maximum credit limit, credit term and the differences in the credit worthiness of the people asking for credit. The duration of residential mortgage credit in the Southern European countries is shorter than in other European countries (duration in Southern Europe is generally 15 years, and in other countries is 20-30 years). Similarly, the amount of credit opened is higher in the countries with higher LTV ratios. The positive correlation between the LTV ratio and mortgage debt is confirmed at the macroeconomic level.
- The difference in the indebtedness of the households among the members of the European Union countries may stem from the different financial policies put into effect within each country, and the incentives put into effect (tax deduction for interest payments, taxes applied to the income obtained from housing etc.) For example, in some countries, an interest reduction in the residential mortgage credit is the issue or in some others, the structure of the marginal tax ratios may affect the attractiveness of mortgage-secured interest payments. Differentiated tax implementation in the buying of houses and other financial assets influences the willingness of the household to be a homeowner an investment.

Although shared tendencies in the EU member countries are observed in the EU mortgage markets, a lot of differences can be observed in these markets. There is growth in the volume of the mortgage debt as well as there is relative growth in the markets of the member countries which does not change. The product range in the market, the profile of the debtor, distribution structures of the funds, credit terms, funding mechanisms, and the rate of owner occupation vary considerably among the member countries.

These differences in the mortgage markets exhibit their conditions related to the member countries' legal procedures, economic history and cultural factors. This result is directly related to direct public intervention in the housing

markets (such as financial incentives making home ownership appealing), market regulations (putting a limit on the amount of credit according to the value of the house to be bought, and on the LTV ratio), competitive conditions in the mortgage markets, and the conditions in the markets for rented houses.

The findings of the many studies on EU mortgage markets and the findings of the research carried out by the European Commission support the view that the EU mortgage markets do not integrate well over the range of mortgage products and cross-border activities. However, the price differences among the member countries are relatively low. In the mortgage bonds and mortgage-backed securities (MBSs) sectors in the primary and secondary mortgage markets of the EU member countries, the link among the national market participants is weak. The direct selling levels of mortgage securities cross-border is very low and is less than 1% of all the credit activities. These kinds of activities are concentrated in the purchase of holiday housing or to a greater extent in the border areas (EC, 2004).

In the EU, where the volume of outstanding mortgage credit reached 50.1% of the EU-27 GDP by the end of 2009, mortgage markets maintain their national characteristics and the importance of these markets changes from country to country. The biggest mortgage markets in terms of the volume of outstanding mortgage debt were England, Germany, France, Spain, and the Netherlands (Table 1). Similarly, the ratios of the residential mortgage credit of the member countries to GDP are seen to be changing in relation to the development level of the countries. In most of the old members of the EU which have more developed economies, the ratio of the residential mortgage credit-to-GDP is 50% or more.

When the data from 2009 is studied, the differences among the member countries of EU can be seen, to a great extent, from the view of the residential mortgage debt-to-GDP ratio (Table 1). For example, the older members of the EU, where the ratio of residential mortgage debt-to-GDP is the lowest, include Italy, Austria and Greece, while the countries having the highest ratio are Denmark and the Netherlands. Also, the new members of the EU are below the EU average, except Cyprus.<sup>3</sup>

While remaining at high levels in several EU countries in 2009, growth rates in the total volume of outstanding mortgage loans fell sharply in comparison with 2006 in a number of other countries. The overall picture was therefore quite mixed, with the new member states of

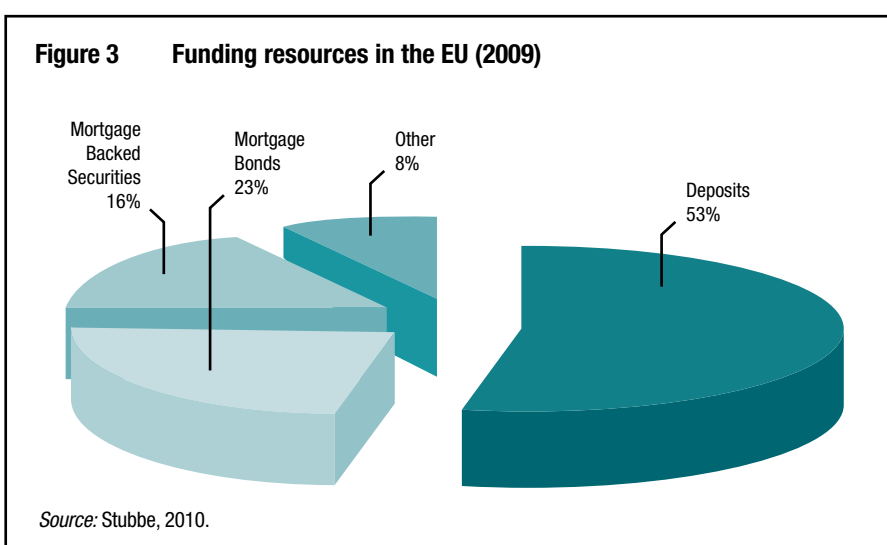
<sup>3</sup> New members of the EU are the countries that become member after 2003.

the EU-27 recording much higher annual growth rates than older EU member states. Only six of EU-27 member states experienced lower growth in the volume of outstanding residential loans in 2009 than in 2008, these were England, Estonia, Greece, Ireland, Latvia and Lithuania, (EMF, 2010). In general, the large differences between the mature markets of the EU-15 countries and that of the new members were confirmed by 2009 figures.

In the mortgage markets of the EU member countries, various funding techniques are used and they differ from country to country. The technique chosen also depends upon the lenders. The most commonly-used instruments to fund the mortgage loans are saving deposits (53%). Also, they have been providing funds from the capital markets by issuing mortgage bonds and mortgage-backed securities (MBS); 39% of the mortgage credit is funded through the capital markets. Almost (23%) of this is obtained through the issue of mortgage bonds and the rest (16%) through the issue of MBS (Figure 3). Three countries (Germany, Denmark and Sweden) in the EU mortgage bond market have 90% of the market. In 1990s, reforms were made which make the issue of mortgage bonds appealing in France, Spain, Ireland and Finland". As a result, in the EU mortgage markets, funding through the issue of MBSs had a share of 1% in 1998, but it increased sixteenfold in 2009 (to 16%). But, retail deposits still remain the predominant of mortgage finance in the majority of EU member countries, though the use of capital market products.

As the mortgage lenders, commercial banks are in a dominant position with a share of 39% in the EU mortgage markets. Mortgage banks playing an important role in Denmark and Sweden, and which have an important role in Germany, France, Greece, Austria and the Netherlands, are in second place in providing funds to the mortgage markets (20%), and the deposit banks are in third place (12%).

In the EU, where the total of the mortgage debt has increased threefold in the last 10 years, the growth rate of mortgage loan has been higher than the growth rate in the GDP. In 2009, the growth difference became even larger although occurring the latest global financial crisis (EMF, 2010). The driving factors of this strong growth were the procedures carried out to participate in a single currency since the beginning of the 1990s to meet the needs of the adjustment to



financial liberalization and the falling interest rates. This environment has led to more competition in the housing markets and has caused the increase of the home buyers' affordability and as a result, has resulted in a rising demand for mortgage loan.

According to research done by the European Commission, the EU GDP is estimated to rise 7%, and the EU private consumption is estimated to rise 5% by 2015, as result of the full integration of the EU mortgage markets., This means that with 2005 prices, EU GDP will rise to 85.8 billion Euros by 2015, and private consumption will rise to 38.7 billion Euros. As the differences in mortgage rates are small among the member countries,<sup>4</sup> this small influence will cause private consumption to rise 0.1% and GDP to rise 0.1%. The new projects to increase the integration of the EU mortgage markets will decrease the mortgage rates to 47 basis points in 2015 and this means that the interest rate repayment will be 470 Euros lower on a mortgage of 100,000 Euros. This 470 Euros of savings would be savings to the consumer only. As those who borrow new funds set aside a fixed amount of their incomes for the repayment of mortgages, the low interest rates may cause them to receive more funds through the mortgage loan and this will cause housing prices to rise. Besides, the decrease in the profit margins of the financial institutions giving mortgaged funds will cause their share values to decrease (London Economics, 2005). The estimated benefits, which could be slightly different today given the evaluation of market

conditions, arise from the increased efficiency of mortgage lenders and availability of a wider range of products (CEC, 2007).

The European Commission, which realized the importance and effect of mortgage credit on the EU economy and its effect on the EU citizens, has put into effect a lot of measures and is still doing so in order to make the mortgage markets more influential and have a more competitive environment. For example, during the Financial Services Action Plan (FSAP) period (2000-2005), more importance was attached to the integration of retail financial services, but it was emphasized that the properties of the products, protection of the consumer, consumption culture, and the role of the structural subjects played a very important role in the financial services markets; for these reasons the integration in the markets would be difficult. In the new politics explained in the White Paper (2005-2010), it was emphasized that the factors impeding beyond-the-border activities and the risks for the consumers should be identified and measures should be taken in this respect. The Commission has determined the integration of mortgage markets to be a priority area in the next years (EC, 2004).

Also, the Commission, which published the White Paper on the Integration of EU Mortgage Credit Markets in December 2007, has set four objectives relating to cross-border supply and funding, product diversity, consumer confidence and consumer mobility. This identified a package of proportionate measures designed to enhance the competitiveness and the efficiency of EU

<sup>4</sup> In the EU, other interest rates other than the consumer credit interest rates are falling and they have converged in the member countries. This convergence of interest rates has grown more with the common currency coming into use. In fact, when German interest rates are taken as a criterion, the interest spreads in the consumer credits change more than 9% (5.02% in Finland, and 4.7% in England). Although it falls down to 5% in the short term credits opened for

the institutions, fluctuation is still very important. (-4.55% in Holland, 0.37% in Ireland). The fluctuation in the middle- and long-term credits fell down to 3% (-1.96% in Finland, 1.1% in Greece), in the mortgage ratios to 2% (-0.99% in Finland, 1.6% in Sweden) and the spread in the premiums of term deposits fell down to 1%. (0% in Denmark, 1.4% in Holland). See EC, 2004. pp. 15-16.

mortgage markets which will benefit consumers, mortgage lenders and investors alike (CEC, 2007).

The proposal for a Directive on mortgage markets followed the White Paper. The Commission prepared the proposal for a Directive of the European Parliament and of the Council on Credit Agreements Relating to Residential Property in March 2011 (EC, 2011b). The twofold aims of this proposal, are indicators of the efforts to create an internal market for mortgage credit against the background of the financial crisis. First, it aims to create efficient and competitive single market for consumers, creditors and credit intermediaries with fostering consumer confidence, customer mobility and cross border activity of creditors and credit intermediaries. Second, it seeks to promote financial stability by ensuring that mortgage credit markets operate in a responsible manner.

In fact, since the products of the mortgage markets include both the monetary markets and capital markets regarding the provision and transfer of funds, developments in the monetary markets and the integration of the capital markets will also enable the development in the integration of the mortgage markets. Indeed, the creation of common standards for institutions in these markets, and in their activities, in the mortgage products in the level of unity, and strengthening the monitoring and supervision of the markets will support the formation of a single EU mortgage market. For example, the new Capital Adequacy Directive (CAD-3) has been prepared to adjust to the existing Capital Adequacy Directive (CAD-2) Basel II to the new Capital Efficiency Accord, which is oriented towards banks operating in the international financial markets. In fact, although the Basel II accord concerns banks operating in the international financial markets, the EU has prepared CAD-3 to regulate all finance institutions. Therefore, mortgage banks operating in mortgage markets are specialized housing institutions that have to take into consideration many directives related to capital and money markets. By the same token, many directives concern the monetary markets, capital markets, mortgage markets, and the integration of the mortgage markets, such as the Prospectus Directive, the Market Abuse Directive, the Markets in Financial Instruments Directive (MiFID), the Transparency Directive, the Directive of Taxing the Deposits, the Directive related to the Undertakings for Collective Investment in Transferable Securities (UCITS), the Directive for the Protection of the Consumer, the Directive related to the Processing and Supervision of the Big Risks of the Credit

Institution, the Council Directive Related to the Beyond the Border Money Orders and the Council Directive Related to the Carrying out of the Activities of the Credit Institutions and their Monitoring (EC, 2005a. EC, 2011b).

### 3. The Comparison of European Union and Turkish Residential Mortgage Markets

EU mortgage markets,<sup>5</sup> which are yet far from attaining the aim of a single market and where the member countries protect their national characteristics, and which take precautions for the integration of mortgage markets, demonstrate differences from the Turkish mortgage markets in various ways (in view of institutions which are active in the markets, product structure, funding resources, level of mortgage rates, LTV ratio, and the instruments used).

The first difference between the mortgage markets in EU and in Turkey comes from the variety of the institutions in these markets. In Turkey, one public institution (HDA) shows activity in the residential mortgage credit markets with commercial banks, which are in the first place.

In the institutions operating in the EU in general, variety is an objective contrary to the situation in Turkey. In the EU mortgage markets, besides the commercial banks, savings banks, cooperative banks, mortgage banks, specialized institutions (building societies, Bausparkassen), insurance companies, and pension funds are active. With the new legal regulations in Turkey, this variety is expected to increase.

The second difference between the mortgage markets of Turkey and EU stems from the volume of the markets. Although the mortgage debt-to-GDP ratio had a significant increase of 4.6% in 2009, this is below the EU-27 average (51.9%). As of the end of 2009, Turkey has a lower ratio than all of EU-27 member countries. When the EU is regarded from the view of member countries, although the mortgage debt-to-GDP ratio in all of them increases with years, it is seen that in some of the old members this ratio is quite under the EU average (Austria, Belgium, Germany, France, Italy, Luxembourg and Greece); however, in some of them it is much above the EU average (Denmark and the Netherlands). In the new members of the EU, mortgage debt-to-GDP ratio is generally under the EU average. Also, level of per capita mortgage debt differs from one another. As of the end of 2009, Turkey,

**Table 2: Housing Market Characteristics**

	Home ownership Ratio (%) 2009	Typical LTV ratios of new loans (%)	Loan Term (years)	Mortgage Rate of new Loans (%) 2009
Austria	56,2	90-100	20-30	3,71
Belgium	78	80-85	20	4,43
Denmark	54	80	30	5,19
Germany	43,2	70-80	20-30	4,29
Greece	80	70	15	3,08
Finland	58	75-80	15-18	2,45
France	57,4	80	15	4,60
Ireland	74,5	70-100	20	2,61
Italy	80	50	10	4,52
Luxembourg	75	80	20	2,03
Netherlands	57,2	87	30	5,37
Portugal	76	75-90	30	2,25
Spain	85	80	15	2,52
Sweden	66,3	80-90	<30	1,43
United Kingdom	70	75	25	4,34
Turkey	69,5	75	5-20	14

Source: EMF, 2010.

<sup>5</sup> In comparison, it will take the EU-15.

that had €0.28 per capita mortgage debt, has a lower ratio than all the EU-27 member countries in 2009—Turkey while the average of the EU-27 was €12,370 (EMF, 2010).

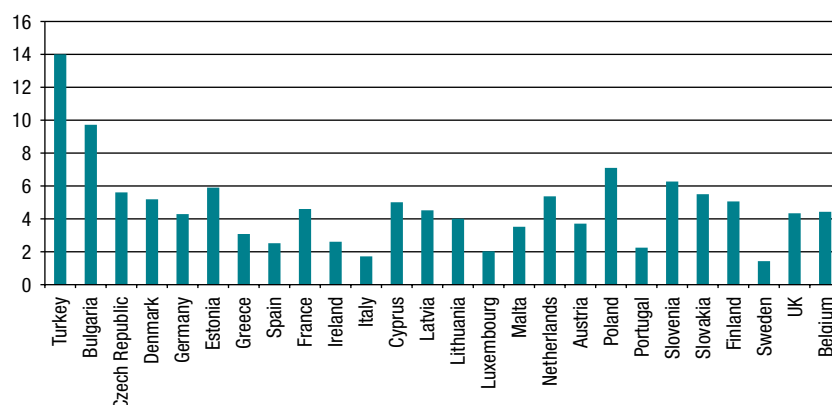
According to the term structure of the residential mortgage credit and LTV ratio, it can be observed that the long term in the EU is 15 years in general, or up to 30 years. Excluding Italy, the LTV ratio is generally over 80%. In Turkey, in recent years, the term has gotten longer (10-20 years) and although LTV ratio has increased to 75%, it is higher only than in Italy.

One of the important differences between the EU and Turkish mortgage markets is the level of mortgage rate. The annual average mortgage rate in Turkey (14% in 2009), in spite of the falling trend in recent years, is about five times the EU-27 figure (Figure 4).

There are some similarities between the EU and Turkish mortgage markets. First, one similarity is in the growth trend of mortgage debt. While in the EU the residential mortgage debt grew 7.4% on average, this ratio has been well over the GDP growth rate. Like EU member countries, in Turkey the growth rate of outstanding residential mortgage debt, which has increased to a great extent in recent years, has been well over the growth rate of GDP, except in the economic crises years (1994, 2000 and 2001 crisis) (Figure 5).

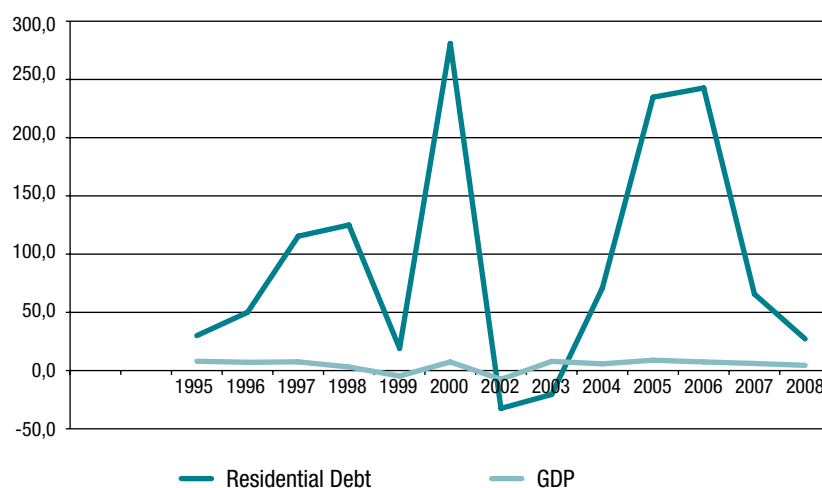
Second, there is a similarity in the main funding source for mortgaged loans. Although there is a big difference between the financial systems of Turkey and EU regarding their volume, the banking sector dominates in both of them. For this reason, in both of them, the savings accounts of the commercial banks are the most important source of funding. The share of the savings accounts in the EU mortgage markets was 53% and in Turkey it is 85.5%. However, in Turkey the second place is taken by budget-resourced funds which are transferred to the market by means of the HDA, a public institution, but in the EU, mortgage markets obtaining funds (23%) by means of the issue of mortgage bonds take second place. Obtaining funds by means of MBSs has increased considerably in the recent years. While in 1998, the share of MBS was 1%, it went up to 16% in 2009.<sup>6</sup> It can be seen that while the increase is provided in the funding of mortgage markets based on the capital market in EU, no development in Turkey

**Figure 4** Representative Interest Rates on New Mortgage Loans (2009)



Source: EMF, 2010.

**Figure 5** Growth Rate in the Residential Debt and GDP (%)



Source: BRSA, CBT.

has been achieved funding based on the capital market yet. But, with the recent regulations made in 2007, more resources are expected to be obtained from the capital markets.

Both Turkey's mortgage market and that of most of the EU member countries have been affected by the global financial crisis, which was triggered by the subprime mortgage crisis in the U.S. Also, the EU mortgage markets were continuously impacted by the worst macroeconomic recession in the EU since World War II. However, in 2009 both Turkey and the EU-27

mortgage market on aggregate experienced a slight recovery as growth in values of outstanding mortgage lending over the previous year returned to positive territory.

## 4. Conclusion

The Treaty Establishing the European Community<sup>7</sup> provided the basis for the creation of a single market and the abolition of obstacles to the free movement of goods, persons, services and capital. However, evidence shows that the single

<sup>6</sup> In fact, the volume of outstanding MBS has dropped back, in 2007 because of the subprime mortgage crisis. After this year, the volume of the MBS in the EU (27) experienced a slight recovery. But the volume of covered bond has continued to increase during the crisis. See: EMF, 2010, pp.90-92.

<sup>7</sup> With Lisbon Reform Treaty, the title of this Treaty has been changed as Treaty on Functioning of European Union since December, 2009.

market for residential mortgages is far from a reality in the EU. There are some obstacles that restrict the level of cross-border activity on the supply and demand sides, thus reducing competition and choice in the market. For this reason, it is apparent that the integration of mortgage markets will take time where national characteristics are strongly felt in the EU, which has been taking a lot of measures since 1990s to provide for the integration of financial markets. Mortgage markets in Turkey demonstrate many differences from EU markets but accomplish many functions from creating capital for real estate to increasing and distributing this capital.

In recent years, the EU has shown important progress in economic integration. However, in spite of the important developments made in the method of forming the single EU, financial market, retail markets and mortgage credit markets, which keep national characteristics, have shown the least integration. For this reason, it is apparent that the integration of mortgage markets will take time where national characteristics are strongly felt in the EU, although it has been implementing a number of measures since 1990s to integrate financial markets.

Currently, it is quite understandable for Turkey, who is negotiating to become a member of EU, to have economic differences with EU in the mortgage markets at this time. The EU, which has put the formation of a single EU financial market among its prioritized aims since the 1990s in order to enable the member countries' financial markets to converge and unify, has made standards determined by international institutions, such as the Bank of International Settlement (BIS) and International Organization of Securities Commission (IOSCO), a part of the Union's regulatory scheme through standards, regulations and directives. Since Turkey is a member of these institutions, of which the key countries of the EU are the founders, the Turkish banking system and capital markets are trying to keep pace with the established standards to a great extent. It is evident that this will make it easier for Turkey's mortgage markets to adapt to the standards set for the EU mortgage markets. In addition, important steps have been taken with the latest legal regulations, providing resources from the capital markets which have gained importance in providing funds in the recent years in almost all EU member countries.

As this is a new regulation, its results will be able to be seen in the middle- and long-term. However, mortgage markets which are still in their infancy, can be said to furnish Turkey with an advantageous position to integrate into the EU. It will be beneficial to take into consideration

the White Paper on mortgage credit, which prepared a package of measures in order to increase efficiency and competition in the EU mortgage markets, and to establish some standards by benefiting from the experiences of the EU countries, such as pre-contractual information, annual percentage rate of charge, responsible lending, valuation, land registers, and foreclosure procedures etc.

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# The Home Mortgage and Real Estate Market in Shanghai

↪ By Jie Chen<sup>1</sup>

**Key words:** home mortgage, real estate market, China, Shanghai

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## SOME FAST FACTS

- Housing prices in Shanghai declined by 2% in 2008 but soared to a record rate of 52% in 2009.
- In the first decade of the 21<sup>st</sup> century, increases in housing prices in Shanghai exceeded the rise in income by around 130% (housing prices grew by 270% vs. income which grew by 146%).
- In the first decade of the 21<sup>st</sup> century, the value of home mortgage loans in Shanghai increased by 10 times.
- In 2009, banks lent 200 billion RMB in new mortgage loans to home buyers in Shanghai, recording a phenomenal increase of 250% from levels in 2008.
- Since 1998, real estate investment has contributed to over 10% of Shanghai's GDP and the added value from the real estate industry currently comprises around 5% of Shanghai's GDP.

## 1. Introduction

Existing literature has analyzed a set of institutional and economic factors that may contribute to the escalating dynamics of Chinese property prices during the last decade, including: a sustained economic boom, limited land availability, stringent land control, increasing urbanization, massive infrastructure projects that have increased the value of land, local governments' heavy fiscal dependence on land revenue, investments from abroad, price speculation, and household investment demands on assets (Eddie and Shen, 2006; Chen et al., 2010). There are also studies that shed light on the operation of the home mortgage business in China, for instance, the risk factors of loan default, the personal characteristics of the users and the possibility of securitization of mortgages (Deng et al. 2005; Li and Yi, 2007). Up until now, research on the relationship between real estate dynamics and mortgage supply in China is limited, partly because there is little data available regarding the Chinese mortgage business.

Using data on the real estate market and home finance in Shanghai, the biggest city and industrial hub of China, this paper analyzes how the development of the real estate market and home finance shows a correlation over the past decade and the focus is their association during the period of global financial turmoil. The long-run trend and policy suggestions thereof are also discussed. The rest of the paper is organized as follows. The next section reviews the existing literature. Section 3 introduces the background of the Shanghai real estate market and home finance business. Section 4 concludes this paper.

## 2. Background

### 2.1. The Real Estate Market in Shanghai

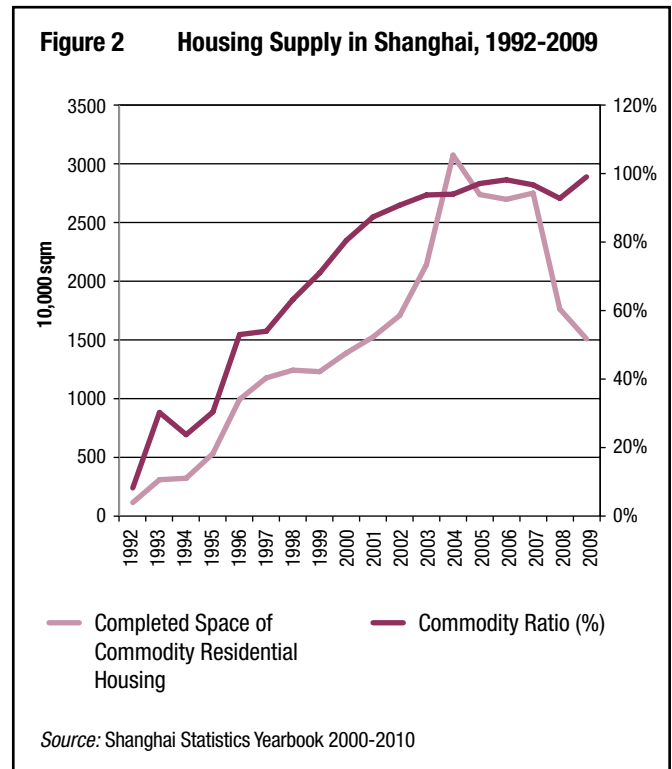
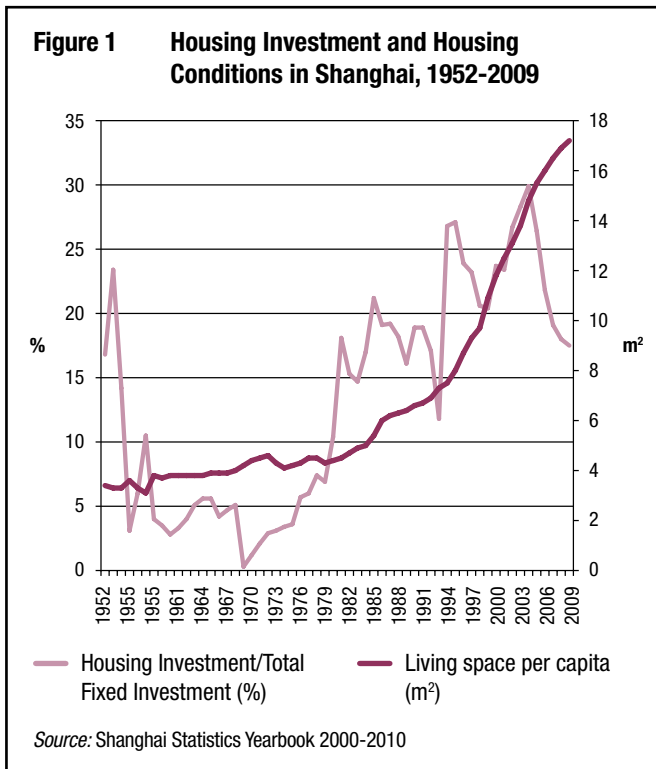
Three decades ago, housing was freely supplied in Shanghai. Before 1978, residential dwellings were considered welfare goods and not commodities in urban China. The majority of urban residents lived under the welfare housing regime in which the government produced and allocated public dwellings at low costs. However, as the state budgetary funding was the only funding source for this housing system, it could not be sustained in economic terms (Zhang, 2006). Under the welfare housing system, like all other major cities in China, investment in residential dwellings was scarce in Shanghai, between 1952 and 1977 housing investment accounted for only 5.8% of total fixed investment (cf. Figure 1).<sup>2</sup> Consequently, the acute accommodation conditions of urban residents in Shanghai experienced little improvement during this period: the living space floor per capita was only 4.5 square meters in 1977, a minimal increase when compared to 3.4 square meters in 1952 (cf. Figure 1).

Under pressure from both housing shortages and budgetary burdens, China initiated a market-oriented housing reform in 1978. In the 1980s, there was a small-scale but concentrated program of selling off public housing. Since the 1990s, a huge wave of privatization in public housing swept across urban China. Revenue from households and enterprises injected new funding into the housing sector (Zhang, 2006). The enthusiasm for housing construction in Shanghai was astonishing after the reform:

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<sup>2</sup> For a similar period, the world average of housing investment as a percentage of total fixed investment and GDP was 20% and 6%, respectively (World Bank, 1993).





between 1978 and 1997, housing investment contributed to 18.72% of total fixed investment and the living space per capita doubled within 20 years (cf. Figure 1).

Alongside reforms in urban land and the housing sector, the Chinese real estate industry emerged in the early 1980s and most industrial and commercial office properties have been supplied through the market since then (Zhang, 2006). Commodity housing built for sale appeared in Shanghai in the late 1980s but most of them were sold to either overseas Chinese or domestic firms and institutions. It was still very rare that Shanghai households purchased homes from the market. The ratio of commodity housing in newly constructed housing rose steadily from 8.1% in 1992 to 54% in 1997 and in 1997, 72.9% of investment on residential housing was bought with intent to sell.<sup>3</sup>

Nonetheless, until 1998 the traditional welfare housing regime continued to prevail in the Chinese urban housing sector and most employees in SOE (State-Owned Enterprises) and government agencies still received free housing from their employers (Zhao and Bourassa, 2003). Therefore, real estate

developers had little incentive to build residential housing as the market was small and the returns were low. The shortage of residential dwellings remained an acute issue in Shanghai and the improvement of urban residents' living conditions lagged behind achievements in economic and income growth.<sup>4</sup>

In the summer of 1998, as a key measure to counter the negative effects of the 1997 Asian financial crisis on economic growth in mainland China, the welfare housing regime was formally terminated (GOSC, 1998). Through a series of policy reforms, the residential real estate industry was completely liberalized in the years following 1998 and quickly became one of most profitable businesses in China. Funding swarmed into promising markets across China at a dazzling rate.

Indisputably, with its massive population, top-ranked prosperity and well-developed legal institutions, Shanghai has always been the number one hotspot for property investors hunting for an opportunity in China. By 2003, the majority of residential dwellings were supplied through the market and the segment of welfare housing constituted only a small margin in Shanghai (cf. Figure 2). The construction speed of new housing in Shanghai increased

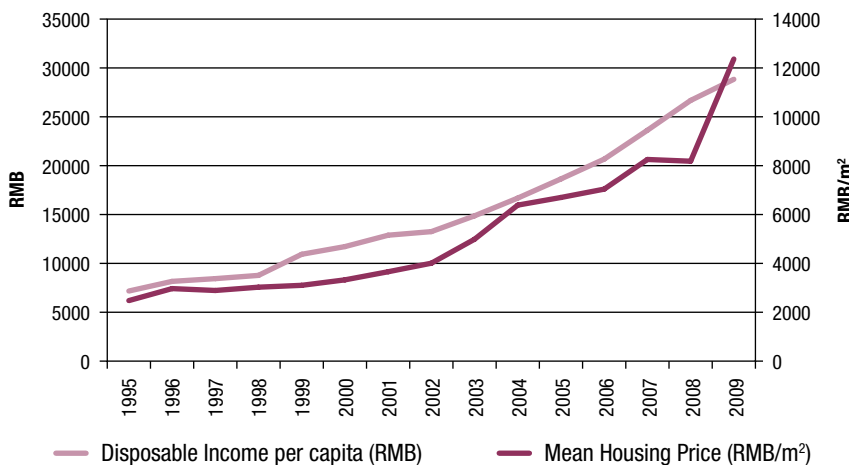
considerably: from 1998 to 2009, investment in housing constituted 22.98% of total fixed investment (cf. Figure 1), the average annual output of residential dwellings was 22.6 million square meters or 1.34 square meters per inhabitant (cf. Figure 2), and the living space per capita doubled within twelve years and rose to 17.2 square meters by the end of 2009 (cf. Figure 1).

The 1998 reform removed the largest obstacle for the development of a free-wheeling, market-oriented real estate market. However, as home purchasing was still a completely new thing to most urban residents, a real estate boom did not come into effect in Shanghai immediately after the reform. Instead, there was only a moderate expansion of trade volume and changes in real estate prices were stagnant between 1998 and 1999, much lower than the income growth (cf. Figure 3). The Shanghai municipal government had to try hard to stimulate enthusiasm for home purchases by employing a variety of favourable policies, i.e., tax returns and granting non-native homebuyers permanent Shanghai household status or *Houkou* (Chen and Hao, 2006). The residential market showed a considerable rebound in 2000 and both prices and trading volume grew at a steady pace.

<sup>3</sup> Until 2000, the commodity housing market in Shanghai was operated through a two-track system that was isolated from each other: one was high-standard dwellings targeted at overseas Chinese and the other was ordinary dwellings reserved for only domestic buyers. Among the latter group, prior to the 1998 reform the majority of buyers were institutions and firms and individual buyers comprised only a small part but it grew from 5.6% in 1988 to 46.3% in 1996 (Chen and Hao, 2006). The two tracks of the commodity housing market merged in 2001.

<sup>4</sup> Between 1979 and 1997, the average annual salary of a worker in Shanghai achieved a three-fold increase (after taking inflation into account) (784 RMB in 1979 vs. 11425 RMB in 1997).

**Figure 3 The Trend of Housing Price and Household Income in Shanghai, 1995-2009**



Source: Shanghai Statistics Yearbook 2000-2010

2002 was a turning point for the Shanghai real estate market. Between 2002 and spring 2005, the market could be described as booming. The trade value of first-hand residential property experienced a steep increase of 50% in 2003 and continued to soar to 86% in 2004 (cf. Figure 3). Based on official data, the mean prices of first-hand residential property grew 19% in 2003 and 28% in 2004, much larger than income growth for the same period (cf. Figure 3). But according to CREI (China Real Estate Institute), the average price of residential property in the downtown area of Shanghai doubled between May 2002 and May 2005.

The skyrocketing real estate prices in Shanghai and other major cities in China appeared out of control in early 2005. This imposed a severe threat to the financial stability and growth potential of the Chinese economy. To cool down the apparently over-heated real estate market, the State Council, issued a series of regulation policies. On the 26<sup>th</sup> of March 2005, the GOSC (General Office of the State Council) circulated a notification to all government agencies and expressed their concerns about property speculation and for the first time made the stability of real estate prices a priority ahead of the development of the real estate industry (GOSC, 2005a). This document was usually referred to as the so-called '*lao guo ba tiao*' (former State Council's eight points). On April 27<sup>th</sup> 2005, the standing committee of the State Council (SCSC) announced the so-called

'*xin guo ba tiao*' (new State Council's eight points) to reinforce the government's bid to crack down on property speculation (Xinhua News, 2005-4-27). On the 9<sup>th</sup> of May 2005, by approving and circulating the real estate market regulation policies suggested by seven ministries including the Ministry of Construction (MoC) and the People's Bank of China (PBC), GOSC stressed again the importance of curbing the rise in housing prices (GOSC, 2005b). During this process, the PBC increased interest rates twice and tightened rules regarding down payments and mortgage terms.<sup>5</sup> Further, since the 1<sup>st</sup> of June 2005 a transaction tax was imposed at the effective rate of 5.5% of the gross resale price for sellers who have owned the property being sold for less than two years.

After this series of reforms, the Shanghai real estate market was brought to a sudden cool-down and the escalating price growth encountered a sharp halt in the spring of 2005. Between May 2005 and July 2007, the mean residential property prices decreased consecutively for eight months with an accumulated fall of 13% and took 17 months to return back the original levels. The trading space and selling value of first-hand housing also dropped in 2005, for the first time since 1998.

Despite the government's various attempts to stabilize the market, an unprecedented real estate boom unexpectedly hit Shanghai and most other major cities in the second half of 2007. Between

August and December of 2007, property prices in Shanghai surged at an astounding speed, growing at least 5% higher than in previous months. According to official data, the trading value of first-hand residential property in 2007 increased 47% from the previous year, while the trading space expanded only 25%. Thus, the mean price grew by 17% in 2007. However, the CREI data suggests that, at the end of 2007, the mean residential property price in the downtown area of Shanghai was 40% higher than one year ago. It is worth noting that, in 2007 the aggregate economic and financial conditions in Shanghai and other major cities in mainland China did not have any substantial changes relative to the last few years and thus the real estate boom was a real surprise to all market participants.<sup>6</sup> Until now, the unexpected 2007 real estate boom is still a mystery to industry observers and researchers.

The State Council did not intervene directly this time but the People's Bank of China acted as a safeguard again. Spiralling prices finally spurred new rigid rules on lending. On the 27<sup>th</sup> of September 2007, PBC tightened the mortgage terms for the application of loans once again: requiring a minimum down payment ratio of 40% and setting the mortgage interest rate to 1.1 times the benchmark loan rate (PBC, 2007a).<sup>7</sup> As it was for the first time the term "the number of loans by borrowers" was used, commercial banks were confused on whether the number was based on loans per household or loans per individual.<sup>8</sup> On the 5<sup>th</sup> of December 2007, PBC issued a supplementary directive clarifying that the number of loans to a borrower shall be determined on the basis of loans made by the borrower's family (including the borrower, his/her spouse and his/her underage children) (PBC, 2007b).

After this announcement, commercial banks began to seriously reduce lending for home mortgages. At the same time, the Chinese government started to rigidly control bank loans to real estate developers. Further, to curb the threat of economic over-heating and inflation, the Central Economic Work Conference held in December 2007 decided to shift from a "prudent" monetary policy, enforced for nearly a decade, to a "tighter" policy. The monetary authority even checked the amount banks could lend with monthly quota limitations.<sup>9</sup>

<sup>5</sup> On March 17 2005, PBC lifted the preferential treatment for mortgage interest rates for the first time since 1999 and unified it with the benchmark long-term loan interest rate: for mortgages older than 5 years, the rate increased from 5.31% to 6.12%. But at the same time PBC allowed commercial banks to give borrowers a maximum discounted rate of 10% of the benchmark rate. The minimum ratio of down payments was also increased from 20% to 30% in cities with rapidly growth of property prices.

<sup>6</sup> *China Daily*, "Shanghai Property Market Keeps Pace", August 20, 2007.

<sup>7</sup> First-home buyers can get preference and are only required to pay 20% of the down payment when buying homes smaller than 90 square meters; otherwise they need to pay at least a 30% down payment.

<sup>8</sup> *People's Daily online*, "Spiralling prices spurred new rules on lending", September 29, 2007.

<sup>9</sup> *China Daily*, "China To Curb Property Loans", Dec 14, 2007.

The property market in Shanghai and other major cities rapidly lost vigour in early 2008. In retrospect, it was very fortunate that the Chinese government happened to cool down its property market before the outburst of the global financial crisis in 2008. Otherwise the market might have experienced a collapse with a much more devastating impact on the Chinese economy. Still, the Shanghai property market encountered a severe crash in the latter half of 2008 and early 2009. The trading space as well as the trading value of first-hand property over the whole of 2008 plummeted 40% compared to 2007 but the fall of mean price was negligible at less than 1%.

In summary, the real estate market in Shanghai had experienced large swings before 2008, with at least two booms and two slumps in the market. Therefore, it is imperative to pursue a stable property market. Besides movements in fundamentals, changes in mortgage credit have been identified as a key driving force behind property cycles.

## 2.2 Housing Stock and Housing Conditions in Shanghai

The last three decades witnessed a massive wave of construction in Shanghai. At the end of 2008, the construction space for all housing in Shanghai was 810 million square meters, which was 10 times the level of 1978, 4 times that of 1990, and 2.5 times that of 2000. Meanwhile, the share of residential housing in the housing stock rose from 48% in 1978 to around 60% in the early 2000s.

Through the privatisation of welfare housing in the 1990s and the market-oriented development of the housing industry in the early 2000s, a large number of residents in Shanghai were able to purchase their own homes. Table 2 shows that, by 2008, the home-ownership rate had risen to more than 77 per cent among Shanghai's permanent residents, with these households split almost evenly between those who purchased welfare housing (and therefore enjoy very low housing costs) and those who

purchased housing from the market. The data does not indicate the proportions of the latter group who had mortgages, but clearly those who did will have experienced much higher housing costs than those who benefited from privatisation. It is worth noting that from 2004 to 2008, the proportion of residents having become home-owners through privatisation fell by 5.1 percent, whilst the proportion having purchased housing from the market rose rapidly by more than 10 percent. By 2008 more residents had become home-owners through purchasing housing from the market than had had done so through privatisation. This suggests that the question of affordability is likely to become more acute as the home-ownership sector matures into one that is dominated by open-market housing (Chen et al. 2010).

Further, nearly half of all residential housing stock was previously public housing that was built before the 1998 reform and the construction quality of these dwellings is generally poor. For example, according to a recent survey conducted by the Shanghai municipal government<sup>10</sup>, the average home size of public rental housing was only 42.65 square meters and the average size of privatised public housing was only marginally larger, at 53.94 square meters. Considering the two kinds of housing, for more than half of the 15 million permanent residents of Shanghai (cf. Table 2) the challenge to meet the demand for new housing among Shanghai local households is substantial.

In the first decade of the 21<sup>st</sup> century, increases in housing prices in Shanghai had exceeded the rise in incomes by 130%; housing prices grew by 270% vs. incomes, which grew by 146%. A recent study carefully assesses the extent in which housing prices in Shanghai are excessive when compared to local income and the results are stunning: the average HIR (Housing to Income Ratio) persistently exceeded 10:1, and at most 20% of local households can afford a standard apartment in Shanghai (Chen et al. 2010). In such markets, housing affordability has become a top social issue and the provision of affordable housing to low- and middle income households is admittedly one of biggest challenges faced by the Shanghai municipal government (GOSC, 2008).

## 3. The Home Mortgage Business in Shanghai

The first home mortgage in China was issued in 1986 (Chen, 2009), but until 1997 this business was constrained and grew very slowly (PBC,

**Table 1: The Construction Space of Housing Stock in Shanghai (10,000 m<sup>2</sup>)**

Year	All Housing	Residential Housing	Residential share (%)
1978	8653	4117	47.58%
1990	17256	8901	51.58%
1995	22094	11906	53.89%
2000	34206	20865	61.00%
2005	64198	37997	59.19%
2008	81121	47195	58.18%

Source: Shanghai Statistics Yearbook 2000-2009.

**Table 2: Housing Tenure in Shanghai (permanent residents) 2004-2008 (%)**

Tenure type	2004	2005	2006	2007	2008
Rental	26.6	26.6	25.1	22.0	21.6
- Public rental	25.9	25.5	23.8	20.4	17.4
- Private rental	0.7	1.1	1.3	1.6	4.2
Home Ownership	72.9	73.3	74.1	77.6	77.6
- Owned: inherited from pre-reform era	2.2	2.4	1.3	0.9	0.7
- Owned: from public housing privatization	42.9	40.4	40.4	37.3	37.8
- Owned: purchased from market	27.8	30.5	32.4	39.4	39.1
Other	0.5	0.1	0.8	0.4	0.8
Total	100	100	100	100	100

Source: Shanghai Statistics Yearbook 2008-2009.

<sup>10</sup> *Wenhui Daily*, "Care for the housing difficulties among the middle-income class" July 30, 2010.

1995; 1997).<sup>11</sup> It is only since the 1998 housing reform that the mortgage market has grown significantly. To provide the necessary financial preparation for the State Council's plan on the abolition of the urban welfare housing system in the summer of 1998, the People's Bank of China liberated the home mortgage business in April 1998 (PBC, 1998). Since 1998, in order to spur households' housing demand and mobilize their home purchasing power, home mortgage loans have been fervidly promoted by banks to common urban households and have quickly become the primary financing tool for Chinese households' home purchases.

The development performance of the Chinese mortgage business since 1997 is truly spectacular. According to the People's Bank of China, the outstanding balance of home mortgage has multiplied more than 250 times between 1997 and 2009, soaring from 19 billion RMB to 4,760 billion RMB. At the end of March 2010, home mortgage loans constituted 12.52% of all banking loan balances issued in RMB and its share in the long-term banking loan was 21%. On the other hand, home mortgages have become one of most lucrative businesses in the eyes of commercial banks. In the early 2000s, the non-performing rate of home mortgages was around 0.15%, substantially lower than the non-performing rate of other loan services (People's Bank of China, 2005).

The home mortgage market in Shanghai has developed much earlier than any other city in China (Chen, 2009). For this reason, the scale of its expansion since 1997 is relatively smaller than the national level, although its outstanding value multiplied 125-fold between 1997 and 2009 and comprises a significant share of the national total (cf. Figure 8). At the end of 2009, the outstanding balance of home mortgages in Shanghai was 391 billion RMB, constituting 13% of all bank loans issued in RMB and 28% of all long-term bank loans (cf. Figure 4).

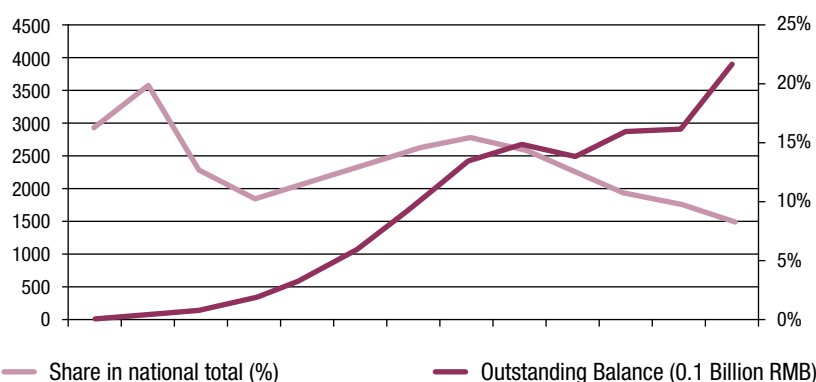
In the literature, mortgage debt, or the ratio of mortgage balance as a percentage of GDP, is often employed to assess the risk status of the home mortgage business. Alternatively, the ratio of mortgages in relation to household savings or total loans is also a useful indicator for mortgage development. At the end of 2009, mortgage debt as a percentage of GDP in Shanghai was 26%, which was in sharp contrast to only 0.91%

in 1997 (cf. Figure 5). However, compared to advanced economies that have an average mortgage ratio of 50%, the mortgage market in Shanghai still has room to develop. In addition, taking into account the low ratio of mortgages compared to household savings, the mortgage business in Shanghai is fairly safe (cf. Figure 5).

The terms of mortgage loans are currently regulated as follows: the maximum loan-to-value ratio is 80% (of the appraisal value or purchase price) (Deng, et al., 2005), and the maximum mortgage term is 30 years. Mortgage interest rates are controlled and set to track central bank rates (ibid.). While new products are emerging, the self-amortizing mortgage remains the most common.

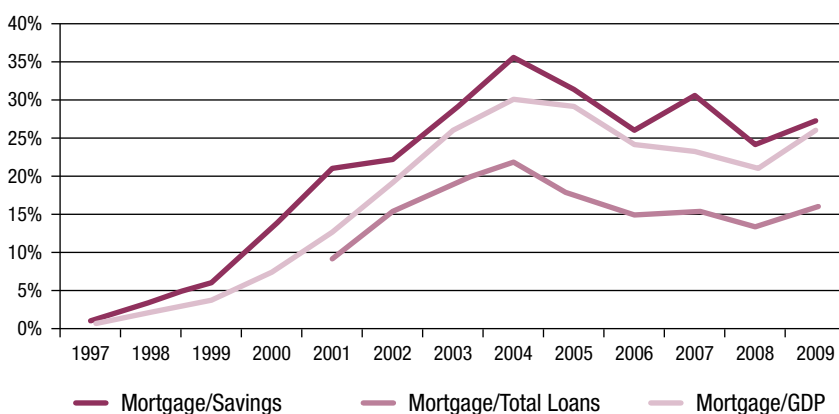
Since the opening of the mortgage business, with funding coming mainly through retail deposits, commercial banks dominate the primary home mortgage market in China and the four major State-owned banks, "the big four"<sup>12</sup>, are the largest market leaders. In 2004, the total amount of home mortgages provided by the four state-owned banks was 1.27 trillion RMB, accounting for 80% of total home mortgage loans in China (People's Bank of China, 2005). However, the mortgage market in Shanghai is much more competitive. The Big Four altogether take up only slightly more than 60% of the market share, and they are facing fierce competition from other national banks as well as local banks. Nonetheless, CCB, one

**Figure 4 Home Mortgages in Shanghai and their National Share, 1997-2009**



Source: Shanghai Statistics Yearbook 2000-2009; Shanghai Statistics Bulletin 2010.

**Figure 5 The Mortgage Debt in Shanghai, 1997-2009**



Source: Shanghai Statistics Yearbook 2000-2009; Shanghai Statistics Bulletin 2010.

<sup>11</sup> For example, by 1995 the maximum length for mortgages was only 10 years, and the regulations asked borrowers to supply a double guarantee when applying for a home mortgage and deposited no less than 30% of the amount that they planned to borrow (PBC, 1995). The 1997 regulations lifted the two requirements but home mortgages were still restricted to only the purchase of housing financed by government subsidies (PBC, 1997).

<sup>12</sup> The Big Four includes: ICBC (Industrial and Commercial Bank of China), AB China (Agriculture Bank of China), BOC (Bank of China) and CCB (China Construction Bank).

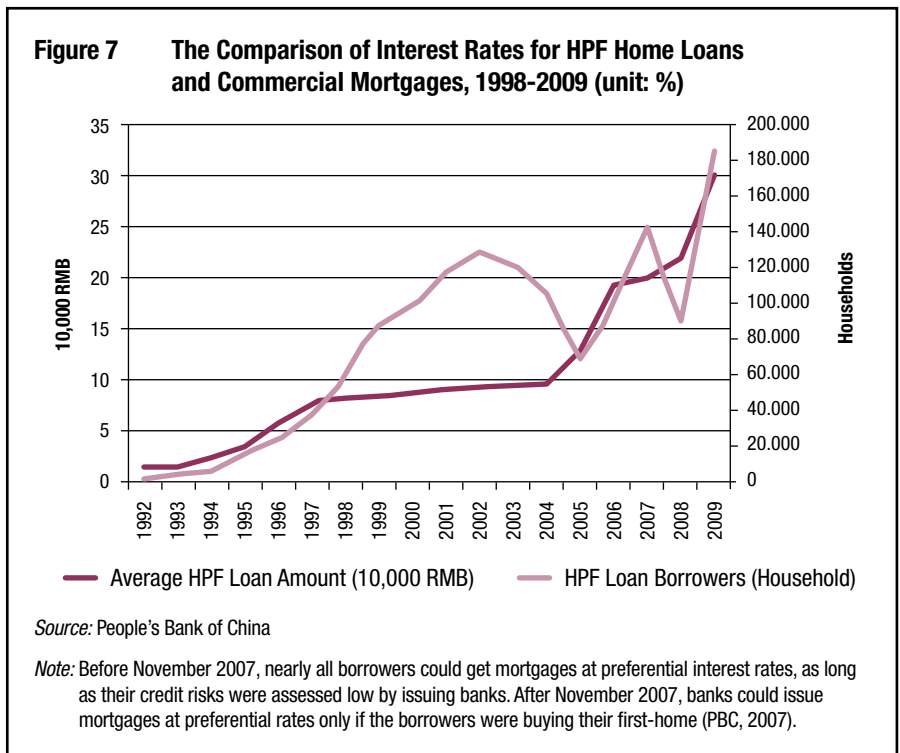
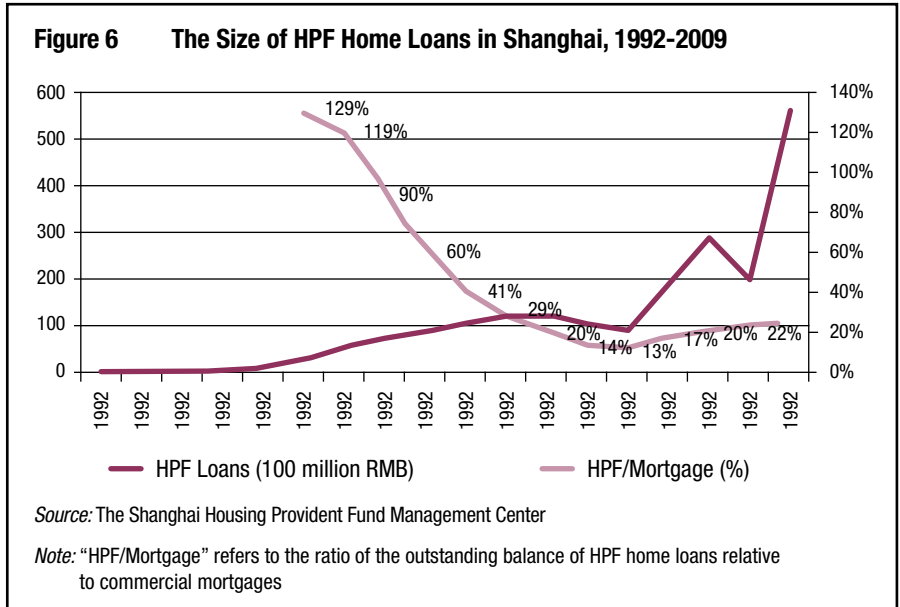
of the Big Four, leads the Shanghai mortgage market with a clear margin and has enjoyed at least a 20% market share since 1999.

### 3.1 Housing Provident Fund in Shanghai

In addition to the western-style commercial home mortgage business, China's home finance system is complemented with the Housing Provident Finance (HPF) scheme, which was first introduced in Shanghai in 1991 and spread nationwide within a few years. Since 1994 the implementation of HPF to all urban employees has been adopted as a national policy (Yeung et al. 2006).

The HPF scheme is based on the Singapore Central Provident Fund and operates in a very similar manner (Duda et al. 2005). Basically, it is a compulsory saving plan with social security purposes, requiring both employees and employers to provide equal contributions of a certain percentage of the employee's salary on a monthly basis. In Shanghai, the compulsory contribution rate was initially 5% and has been fixed at 7% since 1999 but employees and employers are encouraged to contribute additional savings, complementary HPF with a rate ranging from 1% to 8%.<sup>13</sup>The HPF savings are deposited in the participating employee's personal account with interest and all the funds belong to the employee. But before the employee retires or dies, the use of funds is strictly restricted to only housing-related needs i.e. home purchases, self-construction, major housing repairs and renovation, and paying rent under certain conditions.

Within the HPF scheme, participants are entitled to home loans with a preferential interest rate. Actually, until 1998, the HPF home loan was the dominating and maybe the only virtual funding source for personal home purchases in urban China and its development proceeded much earlier than commercial home mortgages. In some sense, the advancement of HPF home loans in the 1990s paved the road and helped much to accumulate experience and expertise for the later development of commercial home mortgages. The business of HPF home loans developed much earlier in Shanghai than in any other city in China. Until early 2000, the HPF loan in Shanghai still constituted one third of the national total.<sup>14</sup> In recent years the ratio has dropped to around 10%. After the People's Bank of China liberated the commercial home mortgage business in 1998 (PBC, 1998), the expansion of HPF



home loans, although significant in itself, is lagging behind that of the commercial mortgages. Currently the outstanding balance of HPF loans in Shanghai is only one fifth of that of commercial mortgages (cf. Figure 6).

There are several factors that restrict HPF home loans from achieving the same growth as commercial mortgages. First, the HPF scheme is implemented among large firms and the public

sector but has little enrolment among small private firms and migrant workers. Even in Shanghai, the city with the most developed HPF system, the participating ratio among all regularly-paid employees is just around 70%. Second, the HPF home loan that one can borrow from is based on a certain multiple of the savings in his/her HPF account, for example, 20 times in Shanghai. Therefore, young employees usually have limited HPF credit to borrow. Third, there is a cap on

<sup>13</sup> As the HPF savings are tax-exempt, both employees and employers have incentives to deposit complementary HPF savings.

<sup>14</sup> Xinhua News 2002-1-10. "The HPF loan in Shanghai exceeded 10 billion RMB": [http://news.xinhuanet.com/fortune/2002-01/10/content\\_233195.htm](http://news.xinhuanet.com/fortune/2002-01/10/content_233195.htm)

the amount of HPF home loans that one household can apply for, which varies substantially across cities. In 2009, the cap for HPF loans was 600,000 RMB in Shanghai but can be extended to 800,000 RMB if the borrower has sufficient complementary HPF savings. HPF also has strict limitations on loans for second home purchases. Given the soaring increase in home prices, the credit from HPF loans is often insufficient for the whole financial needs of one's home purchase (cf. Figure 7). Therefore, most households apply for HPF loans and commercial mortgages simultaneously to finance their home purchase. Fourth, since 1998, the interest rates for HPF home loans do not offer many advantages compared to commercial mortgages (cf. Figure 7).

### 4. Conclusion

The development of the Chinese real estate industry has its roots in the process of economic growth as well as fast-paced urbanization, set into motion in 1978. During the last three decades, the real estate market in Shanghai has experienced several large swings. It has prompted the central government to issue several rounds of new regulation policies to rein in the escalating prices and guard against a devastating housing collapse. Again, tighter control of mortgage credit was the key tool.

While there are numerous studies in house price dynamics in China, few of them considered the direct role of mortgage lending. This paper introduces the historical development of the real estate sector and mortgage business in Shanghai. It is found that the availability of mortgage credit plays a significant role in explaining fluctuations in housing prices in Shanghai. Mortgage credit should be considered a critical factor in understanding housing prices in China. However, the author also stresses that, without major changes in market fundamentals, one may not expect that tightening the mortgage supply could effectively curtail the pace of home prices. Of course, further analysis is needed to shed more light on the relationship between mortgage credit and home prices in China.

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# Rajiv Gruha Kalpha: A pro-poor housing program in Andhra Pradesh, India

↳ By Francis Eddu<sup>1</sup>

## 1. Introduction

Although predominantly a rural country, India is also rapidly urbanizing like several developing countries. In 2001, the urban population of the country was a mere 28%. By the year 2030, however, the urban share of the population is projected to increase to 41%. This rapid urbanization is seen as a rare phenomenon because it took India nearly 40 years (between 1971 and 2008) to reach an urban population of 230 million, whereas the country will add a further 240 million within two decades (McKinsey Global Institute, 2010).

With urbanization, there is also an increase in the number of the poor. The concomitant problems are familiar - housing and shelter, sanitation, water, education, livelihoods, etc. Among several common vulnerabilities for the urban poor which pose a challenge are, housing with lack of tenure and inadequate shelter. In India, the urban housing shortage is projected to be 26.53 million units by 2012, and an overwhelming 97% of the shortage is related to the economically weaker groups in the urban areas (Asia Pacific Union for Housing Finance, 2011).

## 2. Rajiv Gruha Kalpha: State Government Initiative

Hyderabad is the capital of the southern Indian state of Andhra Pradesh (A.P.). The capital is a hub for back office operations for major corporations. The state leads the country for having the largest number of towns and is second among Indian states for its slum population (Census of India, 2001). The Rajiv Gruha Kalpha Program was introduced in the year 2005 in response to the massive growth of population in Hyderabad and adjoining Ranga Reddy districts and to

provide throughout the state low-cost houses in urban areas for the poor and lower income groups (World Bank, 2006). The Hyderabad area saw a high level of migration in the decade 1991-2001, a growth of nearly 18% of its population.

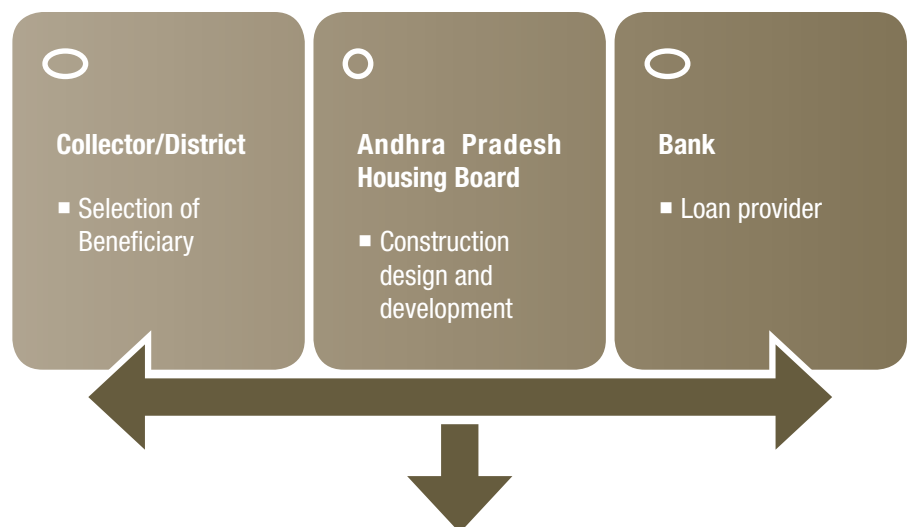
Owning a house is a distant dream for many of the poor groups but the government aimed to make it a reality. The government enacted a series of guidelines for the implementation of the Rajiv Gruha Kalpha Program. The state of Andhra Pradesh [A.P.] has been at the forefront of several innovative housing schemes in India. For instance, the A. P. state bagged fifty per cent of national awards given by the central government in the year 2010 in service delivery and urban development, including pro-poor related reforms and projects (Office of the Chief Minister, 2011).

One of the unique features of the Program is that the government provides land and infrastructure, and if necessary purchases the land on behalf of the beneficiaries. (Samuel,

principal secretary, A. P. Housing Department, personal communication, March 1, 2011)

## 3. Multiple Partners

The Program consists of four major partners: District Collector, A.P. Housing Board (APHB), the beneficiaries, and the banks. The District Collector's office pivots and coordinates the Program; the District Collectors are responsible for the review of the progress of the Program and obtain the targets on the scheduled deadlines. The local/district administration provides land and the necessary infrastructure for free. The A.P. Housing Board supervises construction activities. The banks provide housing loans with a low interest and finance 90% of the cost. The beneficiary selects the housing unit after meeting necessary requirements for the Program. Efforts were made to involve the non-governmental organizations (NGOs) in the loan recovery and livelihood issues after the houses were occupied.



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### 4. Beneficiaries

#### 4.1 Beneficiary Eligibility

- 1) Proof of residence documentation of five years in a town municipal area.
- 2) The annual upper limit of the income is Rs. 36,000 with a minimum of Rs. 24,000 for loan eligibility.
- 3) The beneficiary should not be privy to any other related housing scheme.
- 4) The beneficiary should demonstrate loan repayment capacity.
- 5) Applications that do not meet eligibility criteria are rejected (Andhra Pradesh State Housing Corporation, 2007).

### 5. Steps for House Ownership

#### 5.1 Formal Application

The urban local bodies (ULB) advertise the Program in the newspapers and through other mediums. A non-refundable fee of Rupees 1,100 is charged for the application form. If an application is approved, the fee amount will be used as a part of the down payment and Rs 100 for the application processing. For verification, Iris recognition technology is used to detect false or multiple applications; i.e. to detect fraud and repetition of applicants. The application form gives the beneficiary a list of five locations to choose from (Executive Engineer, A. P. State Housing Corporation, personal communication, March 18, 2011)

#### 5.2 Verification

The personnel from Andhra Pradesh Urban Services for the Poor (APUSP), have devised a set of criteria or survey tool to assess the beneficiaries' needs and cross-check the antecedents of a beneficiary. APUSP is a state project focused on improving the urban poor's access to services in 32 Class 1 towns. The APUSP works to enhance the participation of stakeholders, integrate various government programs, and build capacities of the beneficiaries, planners, and service providers (National Institute of Urban Affairs, 2011).

#### 5.3 Banks

The uniqueness of this program is the tripartite agreement among the beneficiary, the bank and the AP Housing Board. The bank gives a loan with low interest to the beneficiary, who keeps 10% of the cost as a down payment.



*Rajiv Gruha Kalpha integrated township at Bandlaguda, Ranga Reddy.*

The district collector's office shortlists the applicants and arranges an interview with the bank officials to determine if the housing loan can be given. If approved, a tripartite agreement is signed between the bank, Housing Board, and the beneficiary. The housing unit is allotted through a lottery system. The district collector's office communicates with the beneficiary about the lottery date.

#### 5.4 Land

The Andhra Pradesh Housing Board provided the land after a survey in both Ranga Reddy and Hyderabad districts. Suitability of the location and government ownership were the two main factors in land allotment. Since Hyderabad city/district is densely populated, the bulk of the land procured, and the Program houses are in the adjoining Ranga Reddy district.

The Program housing consists of integrated, multi-storied buildings, the land registered in the name of the residents, given by the state government; the land is divided among the residents and a formal ownership title is given to each beneficiary prior to the occupation of an unit. This ownership title, at times, is given to the bank as collateral.

#### 5.5 Design

- a) Each building block is constructed as a four-storied building (ground floor+3 floors) with

24 units/apartments. The plinth area is 250 sq.ft with a clear title.

- b) A housing unit/apartment consists of a multi-purpose room, a bedroom with a bathroom and a small kitchen counter.
- c) Each block has a common area for community activities.
- d) 24-hr water supply, electricity, sanitation, roads, schools, gardens and other related infrastructure is provided.

#### 5.6 Pro-poor housing finance

In India, the public and private housing finance agencies are hesitant to serve the poor with housing finance. However, this Program has attempted to address the non-availability of housing finance to the poor. The APHB developed partnerships with the banks for housing finance for the urban poor. Land and the infrastructure are provided as the subsidy by the government. The beneficiary makes payment for the housing unit over a period of 20 years with (8% a year interest is not "nominal" - editor) interest of 8% (A house of my own, n.d.).

In the Hyderabad and Ranga Reddy districts, the lead bank is the Andhra Bank which co-ordinates with other banks. The district collector's office identifies a particular bank branch based on the location/residence of the beneficiary so that loan repayment can be easily made. The lead bank refers the applicants to the local banks



based on the size. The names of applicants are forwarded by the district collector's office. Banks associated with the Program belong to the public and private sector, regional rural and cooperative banks. The mandatory registration fee of 10%-12% is waived by the government.

The release of funds to the APHB occurs four times, based on the construction stage of a housing unit. Within three months after occupation, the repayment of the loan begins. The loan amount is equivalent roughly to the rent being paid. In case of eight-month default, the bank can seize the unit. Six-month default is included in the loan to protect the beneficiary if ill-health or loss of income occurs.

The involvement or linkage with the banks was due to initiatives taken by government at State Level Bank Committee (SLBC). The banks were apprehensive about the resale value of the units if the loan was defaulted on and the ability of the beneficiary to pay the loan. However, due to the real estate boom in the Program area, it was predicted that a housing unit investment was worth the risk. Then banks also had an incentive to participate in the Program to fulfil their obligation of priority sector lending of 40% under Net Banking Credit. The convener of SLBC provides instructions to the Lead District Managers of the loan amount to oversee the Program and disburse the necessary amount (Finance Department, 2009).

### 6. Conclusion

The Housing shortage is acute in India and the issue is being addressed. For the success of a viable housing finance program, targeting the poor and economically weaker sections is necessary for the desired results. Availability of funds and good houses are constraints for the urban poor. The A. P. state government initiative to rope in banks to provide loans is a unique initiative that has lowered loan processing time and cost. Well-designed townships with transport connections have lessened the commuter barrier. The Program proactively either acquired or distributed government land because land is expensive in urban areas. State intervention in the land supply is one of the major accomplishments.

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Beneficiary in a unit at Bandlaguda, Ranga Reddy.

# The Establishment of the Real Estate Regulation and Supervision Agency of Turkey (RERSAT)<sup>1</sup>

↳ By Yener COŞKUN<sup>2</sup>

## 1. Introduction

The Turkish real estate market has shown noticeable developments in recent years due to various reasons. In this second article,<sup>3</sup> we are attempting to define the pros and cons of the Turkish real estate market. We are also questioning whether the deficiencies may decrease the potential value of the opportunities in the Turkish real estate market, and what kind of measures could be taken for the benefit of consumers/investors in real estate. To analyse these issues, the paper aims to develop a problem-solution framework for the Turkish real estate market.

To our knowledge, with a market-wide approach, this study is the first to attempt an overall evaluation of the Turkish real estate market taking both the positive and negative sides into account. However, this study suffers from limited availability of data and statistical modeling. Nevertheless we believe that the perspective and policy suggestions contained in this study will be found challenging.

For a better disciplinary framework for public/market based real estate activities, we suggest that a Real Estate Regulation and Supervision Agency of Turkey (RERSAT) should be established as a new government agency. In our view, the primary expectation of this agency would be to enhance public interest, customer protection and market efficiency in the real estate market.

The paper is organised into four further sections. In sections 2 and 3, we analyse advantages and disadvantages of the Turkish real estate markets. In section 4, we argue that RERSAT should be established to solve current inefficiencies of the Turkish real estate market. The last section is reserved for the conclusion.

## 2. Advantages in the Turkish Real Estate Market

In sections 2 and 3, we attempt to classify both the advantages and disadvantages of the Turkish real estate sector to define an objective framework for the long term cost-benefit analysis.

According to statistics, Turkey is considered to be a promising country in the greater European region. If it is managed effectively, the country offers several economic benefits to its trade partners and investors. Like other immature sectors, the real estate market also offers opportunities.

In this context, there are positive foundations on which to build, in demographics and urbanisation. Istanbul, as an emerging mega-city, offers several advantages for investors/developers. Additionally, there are public policies on infrastructure investments, land development and social housing. There is an atmosphere of dynamic and creative entrepreneurship. Other

factors favouring strong demand are the advantages of Real Estate Investment Trusts (REITs), the advantages of being a late comer, developments in regulatory framework and developing academic knowledge. These factors would all be classified as opportunities (or positive factors) supporting the potential of the Turkish economy and real estate business. These factors can make positive contributions to the expected rate of return on investment in the Turkish real estate market.

Some of the above-mentioned factors are already well analysed in the literature. Therefore, methodologically, it would be useful to examine the positive impacts of motives in domestic demand, plus the importance of Istanbul and of REITs.

### 2.1. Motives in Domestic Demand

A high inflationary environment and negative real interest rates, which for many decades were a mainstay of the Turkish economy, resulted in unusual investment patterns for both Turkish households and corporate sectors. During this period, the emphasis was mostly on investment in precious metals (specifically the gold market) and real estate, specifically the housing market (Coşkun, 2010a: 30).<sup>4</sup>

In addition to being a major asset class in the household saving (investment) stream, real estate also represents one of the symbols of

<sup>1</sup> This article is essentially based on the working paper "An Analysis of the Opportunities and Weaknesses of the Turkish Real Estate Market" (17 th Annual ERES Conference, Milano/ITALY), see, Coşkun (2010c). The findings, interpretations, statements and conclusions expressed herein are those of the author alone and do not necessarily reflect the views of the institutions connected with the author.

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<sup>3</sup> This article is second of a pair of articles. For the first article, see Coşkun (2011a).

<sup>4</sup> It would be better to analyse Coşkun (2011a) and also this article simultaneously to give a realistic view of the Turkish real estate market.

**Table 1: Opportunities in Turkish Real Estate Market**

Opportunities (D/S)	Signs/Criteria	Impact (P/N)
<b>Positive Fundamentals (D)</b>	Geo-political position; EU candidacy; industrialisation; growing/stable economy	P: Increase R/C/L demand with growing FDI N: Increase real estate prices/rents
<b>Demographics (D)</b>	Benefits of window of opportunity	P: Increase public infrastructure investments and R/C/L demand N: Growing unemployment and crime rates.
<b>Urbanisation (D)</b>	Rapid and continuous immigration to urban area	P: Increase urban renewal; public infrastructure investments; R/C/L demand. N: Increase irregular urbanisation; urban land shortage; rent-seeking activities; <sup>5</sup> marginal sector activities
<b>Istanbul (D)</b> (see, 2.2)	Fast growing mega-city	P: Istanbul offers several advantages for retail, commercial and industrial RE projects. N: Increase socio-economic problems (i.e. gated communities, real-estate based wealth transfer mechanisms against public benefit)
<b>Motives in Domestic Demand (D)</b> (see, 2.1 and 2.2)	RE ownership is symbol of socio-political statute, major asset class in the household saving stream and big bet in rent seeking activity (specifically for land demand)	P: Increase R/C/L demand. N: Increase unlawful activities (i.e. squatter settlement)
<b>Other Factors for Strong Demand (D)</b>	Growing number of super wealthy people <sup>6</sup>	P: Increase demand on high-end buildings and niche residential/hotel projects N: Further social division
	Demand from unobserved economy <sup>7</sup>	P: Increase R/C/L demand N: Ruin statistics; public benefit/policies; reshaping socio-political structure
	Growing FDI and foreign home ownership <sup>8</sup>	P: Help to finance CA deficit; increase R/C/L demand and RE prices N: Rising doubts on foreign ownership
<b>Public Policies on RE Supply (D/S)</b>	Increasing volume of land development, infrastructure investments, social housing and urban regeneration projects by central /local governments and Housing Development Administration (HDA). <sup>9</sup>	P: Increase (social) house supply; benefits to rural development/urban renewals. N: Problems in the growing public economy/HDA type social enterprise; distortions on free market
	Privatisations/selling of public properties	P: Opportunities for land developers. N: Increase rent-seeking activities.
<b>Public Infrastructure Investments (D/S)</b>	Regional development projects (i.e. South- Eastern Anatolia Project/GAP), <sup>10</sup> highways, energy investments etc.	P: Increasing the number of construction projects requiring financial needs, technical advisory, PPP, market research etc. N: Problems in doing business with central/local governmentd
<b>Supply Side Framework (S)</b>	Dynamic and creative entrepreneurship in residential/commercial construction sector	P: Increase supply/competition; develop quality of R/C and land management; enhance sophistication N: Unplanned house supply, growing RE bubble risk; risk/liquidity management problems in construction firms and their creditors
	Growing number of foreign firms <sup>11</sup>	P: Increase technical knowledge and competition
	Developing construction technics/architectural quality	P: Increase R/C quality/supply elasticity
<b>Advantages of REITs (D/S)</b> (see, 2.3)	Active REITs market in ISE	P: Increasing institutionalisation, transparency and financial opportunities for REITs; enhancing transparency in construction sector
<b>Being a Late Comer</b>	Using other countries' experience	P: Decreasing costs
	No RE originated crisis	P: Decreasing costs
<b>Developments in Regulatory Framework</b> (see, 3 and 4)	CMB's and other government institutions' initiatives	P: Increasing efficiency/regulated-licensed activities N: Problems of integrity among regulatory authorities
<b>Developing Academic and Professional Knowledge</b>	Several universities offer MSc programs and Ankara University offer PhD program in RE. Several international RE organisations in the market (i.e. RICS, ULI)	P: Increasing knowledge, professionalism and education in RE markets.

D/S: The factor essentially impacts to demand/supply side of the RE market; P: Positive impacts; N: Negative impacts; R: Residential RE; C: Commercial RE; L: Land (for development); ISE: Istanbul Stock Exchange, RE: Real estate; CA: Current account; CMB: Capital Markets Board of Turkey, FDI: Foreign Direct Investments.

Source: Author.

<sup>5</sup> High revenues obtained from urban land transactions intensified conflicts over property rights among many actors (Güloksüz, 2002: 474).

<sup>6</sup> According to Forbes (2008 and 2009), the number of billionaires in Turkey was respectively 35 and 13 in 2008 and 2009. These numbers are 24 and 17 in Japan; 18 and 8 in Spain; 13 and 6 in Italy and 13 and 14 in Saudi Arabia.

<sup>7</sup> It is estimated that unobserved (informal) economy may consist of 35% - 60% of Turkish economy. Researchers may analyse interactions between housing demand and unobserved economy in future researchs. As a general observation, we think that the construction sector, unobserved economy and corruption economy have unclear but strong reciprocal connections in Turkey.

<sup>8</sup> According to the data of land registry, there are a total of 73.000 foreign home owners distributed in an area of 38.419.000 m<sup>2</sup> [in Turkey] (Turkey Real Estate Yearbook, 2008: 87).

<sup>9</sup> A detailed analysis for the social housing and HDA, see, Coşkun (2011b: 17-27).

<sup>10</sup> The scheme covers an area of 9.5 per cent of the total land area of Turkey, and has 8.5 per cent of the population. The area will contain 20 per cent of the 8.5 million hectares of irrigable land in Turkey when the project is complete. The cost is likely to exceed 32 billion USD. Objectives are to mobilise regional resources and reduce disparities (Bullard, 2007: 94).

<sup>11</sup> In the domestic real estate market, there are increasing number of foreign firms/initiatives in various sectors such as construction, brokerage, financial investment etc.

socio-political status in the country. Specifically in the case of the less-developed/rural regions of the country, more land means more political power and also input into agricultural production. On the other hand, rising land prices and growing profit opportunities in urban areas increase real estate demand from land speculators, developers and investors.

Spending on housing finance and rent makes up a considerable part of consumer spending in Turkey. In this context, The Housing Department of Turkey (2003: 5-16) indicates that in the year 1965 residential leaseholders consisted of 38.66% of all households. This ratio declined to 31.6% in the year 2000. In other words, 3.5 million people have monthly rent payment in Turkey. Therefore, the residential leaseholders could be seen as potential mortgage buyers if affordable loans were available. On the other hand, the data from the Central Bank of the Republic of Turkey (2008: 23) shows that housing credits consist of 33.3% of all housing debt in the 2008/Q1 term.

According to Eurostat, in EU-27, total of nearly three quarters (73.6%) of the population lived in

owner-occupied dwellings, while 13.0% lived in dwellings with a market price rent, and 13.5% in reduced-rent or free accommodation in 2009.<sup>12</sup> On the other hand, the average home ownership rate is 68% in Belgium (in 2001), 80% in Italy (in 2002) and 75% in Poland (in 2004) (The European Mortgage Federation, 2007: 124). According to TurkStat and The Housing Department (2003: 4) the owner occupation rate is 68.2% in Turkey. But, as indicated by Kongar (2003: 562), the average home ownership rate in urban areas is below 40%.

## 2.2. Opportunities in the Istanbul Real Estate Market

The real estate market in Istanbul provides important opportunities for both domestic/foreign investors/consumers. There are several official and private sector reports which analyse the opportunities in the Istanbul real estate market.

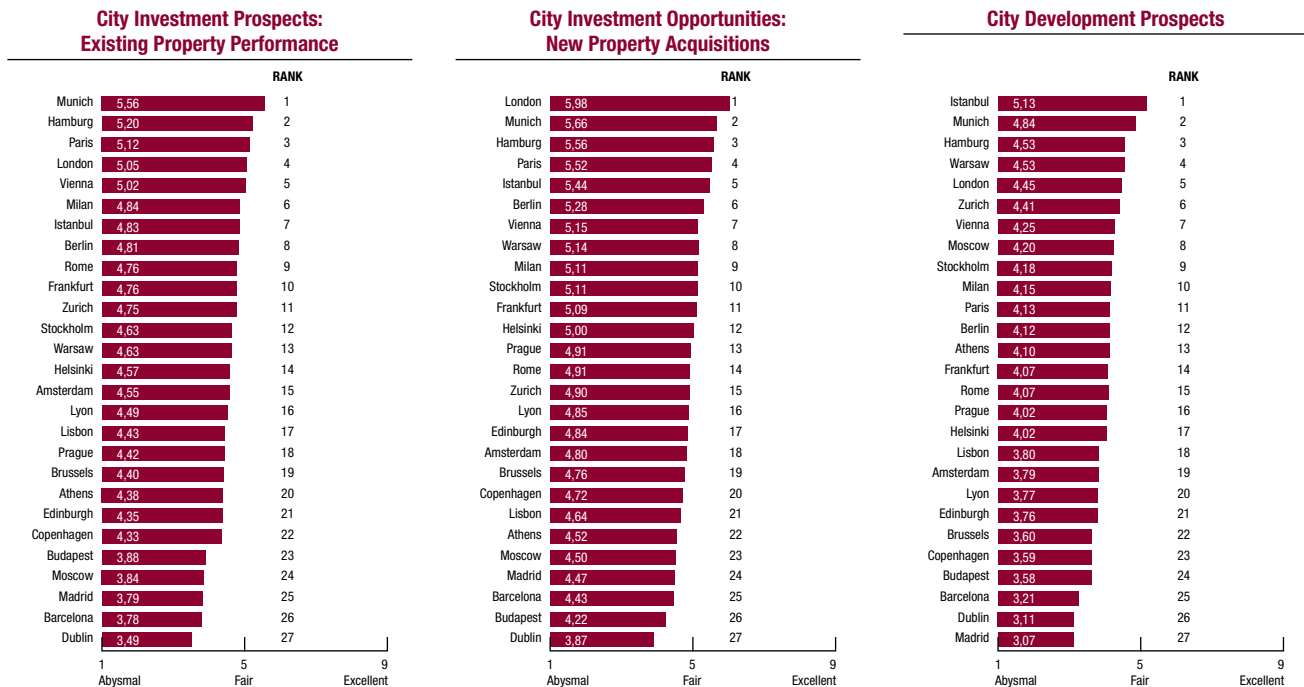
In the report Emerging Trends in Real Estate Europe 2010, ULI and PwC (2010: 9, 35) ranked Istanbul third for investment prospects and first

for development. According to existing property performance and new property opportunities, Istanbul seems to be one of the leading markets.

Istanbul is the most critical driver of the real estate investment in the country and still needs more office space,<sup>13</sup> upper/middle class residential, commercial and hotel investments.<sup>14</sup> Although estimates vary, there is a striking housing shortage in the urban areas of Turkey. Taking into account demographics, immigration and the current housing shortage it seems logical to assume that the residential sector would be the leading sub-sector in the real estate market. In this context, Istanbul probably needs more residential development projects in the near future.

Most Turkish provinces are likely to experience sizable population growth over the next twenty years. The population in the provinces of Antalya, Bursa and Istanbul is likely to increase by more than 30% over that period. In recent decades a significant part of the land use changes as a result of the population expansion in Turkish cities has not followed an urban development plan but was rather driven by unlicensed building activities. As an example, the built-up area

**Figure 1 Istanbul Real Estate Market (2010)**



Source: ULI and PwC (2010: 9, 28, 29).

<sup>12</sup> See, [http://epp.eurostat.ec.europa.eu/statistics\\_explained/index.php/Housing\\_statistics#Tenure\\_status](http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Housing_statistics#Tenure_status) (01.06.2011)

<sup>13</sup> It is estimated that 5 million sqm new office space will be required in the next 10 years in the largest 25 cities (Altan, 2009: 18).

<sup>14</sup> While Istanbul will undoubtedly remain the focus of occupier, developer and investor interest into the foreseeable future, accounting for 40% of Turkey's modern retail stock and 80% of its modern offices, there are emerging opportunities beyond Istanbul, growing on the back of increasing dynamism (Jones Lang Lasalle, 2008: 3).

in the province of Istanbul increased by more than 40% between 1990 and 2005. (Deutsche Bank Research, 2008: 6-7).

It would be interesting to note that the growing importance of financial services in Istanbul may result in a further expansion in the real estate market. The importance of the finance sector in Turkey is growing due to several reasons. Thanks to the changing political environment in Middle East<sup>15</sup>, a steady growth in the Turkish economy and the worldwide negative impacts of the global financial crisis brought into question whether Istanbul can become a safe harbour in the region. According to a Global Financial Centers Report (6, 7) of Z/Yen (2009: 19; 2010: 5), Istanbul is one of the emerging financial centers in the world. Domestic reports also analyse Istanbul's position as a financial center (see, The Association of Capital Market Intermediary Institutions of Turkey, 2007; The Banks Association of Turkey, 2007 and 2009; State Planning Organisation, 2009). As a State policy, the Turkish government promotes Istanbul as a financial centre. It seems too optimistic to assume that Istanbul will become a financial centre within the next 10 years.<sup>16</sup> But like other sectors, the real estate sector may profit from these policies.

### 2.3. Advantages of REITs

Current REITs regulations offer leverage opportunities to real estate companies in Turkey. In this context, according to relevant regulations, REITs are exempted from corporate and income taxes. The freedom of REITs to choose their dividend policies must also be taken into account, Erol and Tirtroğlu (2008: 2694) indicate that Turkish REITs have significantly more flexibility in managing their portfolios than their counterparts in developed countries.

At the end of 2009, there were 14 REITs listed on the ISE (Istanbul Stock Exchange) which had a portfolio value of 3,2 billion USD. The portfolio of REITs is composed of real estate investments (69.54%), real estate projects (17.44%), other securities (8.63%) and government bonds/T-Bills (4.39%) (Capital Markets Board of Turkey, 2010: 23, 45). Following the CMB's policy change<sup>17</sup> which aimed to create a positive atmosphere for public offering of REITs, there are 22 REITs at the ISE, as of June 2011.<sup>18</sup>

As seen in the above table, although their market capitalisation is relatively small, Turkish REITs represent an alternative financial channel to real estate companies and capital gain opportunities to investors.<sup>19</sup> Total debt to gross assets as of 31.12.2009 is 0.03% and market price to net assets is 0.34% in the sector (Ernst&Young, 2010: 15). However, the limited growth of the sector, and unsatisfactory stock performance indicate that the (corporation and income tax) incentives are yet insufficient to ensure a healthy growth of the REITs industry in Turkey (Aydinoğlu, 2004: 52). However, we may argue that if the current relatively stable economic conditions continue, and specifically finance-real estate linkage (see, line 6 of Table 3), develops in the near future, the REITs market with its transparent structure would be the very first candidate to upgrade its position.

### 3. Disadvantages of the Turkish Real Estate Market

While, the Turkish economy offers advantages to potential investors, the potential return comes with risks. In this context the difficulties could be classified as, fundamental instabilities, infrastructure problems, institutional deficiencies, irregular activities, inefficient finance-real

estate linkage, appraisal problems for market/public based transactions and problems in land/cadastral information systems, problematic decision-making process of public sector/judicial system. These factors are decreasing visibility, transparency, expected rate of return, legal security and fair transaction opportunities in the Turkish economy/real estate market.

As indicated the above problems may decrease the rate of return on real estate investments in Turkey. Among these factors we would emphasize the negative impacts of lack of data availability, problems in real estate valuation and less developed framework of protection of public/consumer benefits.

### 3.1. Data Availability and Problems with Transparency

There is no sound/generally accepted official/unofficial value map in Turkey. The availability of price information is relatively better via internet sources and real estate brokers, but there are still problems in the quality of the data from these sources. On the other hand one can get unofficial sales and rent information/statistics on shopping centers due to their commercial characteristics. In addition to difficulties in data

**Table 2: REITs in Turkey and Selected Countries (2007-2009)**

Country	Market Cap (2009) (mn, USD)	Total rate of return (% , 2009)	Total rate of return (% , 2007-2009)	Weighted Average Dividend Yield (2009)
Turkey	1,889	151.3	-1.8	*
U.S.	271,850	27.9	-14.2	5.6
U.K.	37,176	14.5	-26.3	4.6
Malaysia	1,542	38.6	10.2	3.7
South Africa	3,400	17.5	12.4	8.5
South Korea	132	28.4	12.1	8.4

\* Insufficient data. Source: Ernst&Young (2010: 11).

<sup>15</sup> Some expect that Turkey may derive economic benefits in the new political order of the Middle East. According to this view, Turkey may become a financial/political bridge in her region and also between East and West.

<sup>16</sup> To analyse problematic sides of the Istanbul see, OECD (2008) and Ipsos (2009). For a detailed analysis for the idea of Istanbul Financial Centre, see Coşkun (2011c).

<sup>17</sup> Communiqué Serial: VI, No: 26 on Amending Principles Regarding Real Estate Investment Companies has made amendments about; the ratio of IPO (decreasing the ratio from 49% to 25%) and a new provision that obligates them to offer their shares to the public within 3 months

after being established. (Official Gazette No. 27449, dated December 31, 2009). (Capital Markets Board of Turkey, 2010: 61).

<sup>18</sup> See, <http://www.imkb.gov.tr/Data/IPODData.aspx> (01.06.2011).

<sup>19</sup> See, Erol and Tirtroğlu (2008) for evidence on inflation hedging performance of Turkish REITs in the period of 1999/Dec-2004/Dec.

**Table 3: Disadvantages of Turkish Real Estate Market**

Disadvantages (D/S)	Signs/Criteria	Impact (P/N)
<b>Fundamental Instabilities (S/D)</b>	Implicit socio-economic/politic instability, unemployment, inequality of income, poverty etc.	N: Increase social fragility/exclusion; housing finance costs; political-economic risks, (i.e.: increasing CDS premium, real interest rates); reduce sustainable housing production etc.
<b>Infrastructural Problems (S/D)</b>	Inadequacy of water, electricity and other public services.	N: Problematic/ unsophisticated urbanisation; increasing illegal housing/irregular activities.
<b>Institutional Deficiencies (S)</b> (see, 3.1 and 4)	Complicated <sup>20</sup> /problematic/less effective legal system in RE business	N: Decrease visibility/transparency; increase irregular activities and legal problems.
	Unplanned changes in central/local government RE policies (i.e. tax system, zone practices <sup>21</sup> etc.)	N: Decrease visibility/transparency; increase irregular activities; damaging fair competition; increase rent seeking activities in urban area.
<b>Irregular Activities (S/D)</b>	Less transparency in RE markets, capturing legal system	N: Growing corrupt economies at the expense of fair market practices
<b>Supply Shortage in Affordable Housing (S/D)</b>	Squatter settlements; quality problem in existing housing units, growing demand for social housing	N: Socio-economic problems. N/P: Growing function of HDA as social enterprise. <sup>22</sup>
<b>Inefficient Finance-RE Link (S/D)<sup>23</sup></b>	Less developed credit/insurance markets for housing finance	N: Non-institutional finance is the main source of housing finance; decreasing the level of housing affordability; less developed financial markets
	No secondary mortgage market at ISE	N: Less developed capital markets/risk management practices; limited growth potential for housing credit market; increase liquidity/credit risks in banking.
<b>Problems in RE Appraisal (D/S)</b>		
Appraisal Problems in Market Transactions (see, 3.2)	Less developed appraisal profession/culture; less/inefficient supervision for appraisal practice	N: Problematic price/value formation; Increase asymmetric information problems in RE/finance markets; increase credit risks in banking.
Appraisal Problems in Public Transactions (see, 3.2 and 3.3)	Less developed appraisal profession/culture, complicated legal structure; public interest (State) accepts superior than the individual interest.	N: Appraisal for public based transactions may impair ownership rights/free market economy; problematic price/value formation.
<b>Problems in Information Systems (D/S)</b> (See, 3.1)	Less effective land information system; <sup>24</sup> No sound value maps	N: Less information to price formation/valuation/credit-capital markets
	No sound current/historical real estate sales/rent values; no official house sale/rent index	N: Less information to price formation/valuation/credit-capital markets
	Less efficiency in the transactions of Land Registry Office	N: Negative impacts to transactions/legal procedures
	Less efficiency in rural cadastral information	N: Negative impacts to real estate supply/ownership rights/agricultural production.
<b>State Sector Problems (S/D)</b> (see, 4)	No effective management in public properties	N: Less marketable land in urban area; increasing cost of land/irregular housing; inefficient use of rural land
	Problems in expropriation	N: Important appraisal and legal side problems
	Problems in land consolidation <sup>25</sup>	N: Decreasing agricultural productivity, increasing political problems
	Many authorities in RE regulation/supervision (specifically for development rights)	N: Increasing inefficiency/transaction costs in private/public RE management; growing corrupt economies
	Problems in urban planning and property laws	N: Growing informal housing markets/marginal sectors, increasing legal problems.
<b>Problems in Judicial System</b>	Less developed professional witness system for RE appraisal	N: Time-consuming, costly, problematic, unfair legal system

D/S: The factor essentially impacts to demand/supply side of the RE market; P: Positive impacts; N: Negative impacts; R: Residential RE; C: Commercial RE; L: Land (for development); ISE: Istanbul Stock Exchange; RE: Real estate.

Source: Author.

<sup>20</sup> General Directorate of Land Registry and Cadastre underlines that there is a complicated structure in the registry and cadastre transactions in Turkey (General Directorate of Land Registry and Cadastre, 2009: 54).

<sup>21</sup> The number of zoning plan changes was presumably 20.787 in Turkey in the period of 1965-1978. On the other hand, there were 3.900 zoning plan changes in Istanbul municipality between 2004-2007 (Turan, 2009: 131).

<sup>22</sup> It is estimated that the social house production of HDA consists of 5-10% market share in housing sector. Some argue that this level of public intervention creates distortions in the housing market (see, Coşkun, 2011b: 17).

<sup>23</sup> The link between finance and real estate in terms of access to primary/secondary mortgage markets is weak in Turkey. In other words, it can be statistically observable that the real estate

sector growth may not reflect the acceptable amount of growth in primary/secondary mortgage markets in Turkey (see, Coşkun, 2010b and Coşkun, 2011a: 11).

<sup>24</sup> Turkish national land registry is not a member of European Land Information System (EULIS) (see, <http://www.eulis.eu/countries/>). According to a relevant official report, land information systems are less developed in Turkey. But, there are various projects to enhance the system (General Directorate of Land Registry and Cadastre, 2009: 5, 54 and <http://www.tkgm.gov.tr/ana.php?Sayfa=icerikana&ICID=113,27.04.2010>). Also see, Bank and Mataracı (2004) and Çete et al. (2010).

<sup>25</sup> According to a relevant official report, there are problematic land-use practices in Turkish agricultural enterprises (i.e. small scale, fragmentation etc.) (The Ministry of Agriculture and Rural Affairs The General Directorate of Agrarian Reform, 2009: 16). In the EU, the average farm size is 16 hectares compared with 6 hectares in Turkey; the average number of land parcels per farm is six (average size of one hectare) (Bullard, 2007: 95).

acquisition, the absence of a real estate index<sup>26</sup> also results in transparency problems in the process of pricing, valuation and hence in the overall investment process.<sup>27</sup> It is important to note that this non-transparent structure would impair a rational decision-making process in the real estate sector for all market players.

## 3.2. Real Estate Valuation: Problems and Outcomes

The existence of a professional and independent appraisal service is vital for increasing the credibility of the industry from the perspective of investors (Aydınoğlu, 2004: 52). The problems of data availability and less developed real estate appraisal have caused important consequences.

Firstly, from the perspective of fair price assessment, the problems of data availability, and less developed real estate appraisal imply problems in the marketplace. It is expected that this structure may impede negatively on incentives for buyers'/sellers' in both residential and commercial markets.

Secondly, a less transparent price mechanism/information may also impair the credit/securitisation markets by increasing information asymmetry and hence credit/securitisation risks.<sup>28</sup> Anecdotal evidence suggests that over competition within the Turkish banking sector may also support this negative development.

Thirdly, appraisal problems may also create a negative impact on the marketability of real estate and lead to dissatisfaction amongst real estate investors. Categorically, real estate and stock market investments are incomparable. While real estate shows unique characteristics/heterogeneity, stocks show homogeneity as an asset class. But it would be useful to analyse the current positions of real estate investors by using stock market investment as proxy. Even unsophisticated stock market investors may easily access lots of information including up-to-date/historical prices, several stock market indexes, information on market crimes etc. In the case of

real estate markets, even sophisticated investors may face significant information asymmetries arising from the absence of sufficient information.<sup>29</sup> In this context, higher level of information asymmetries may lessen marketability and/or increase price volatility of the rural/urban properties. This picture also creates incentives to pursue unfair/irregular practices in the real estate market.<sup>30</sup>

## 3.3. Public Interest and Consumer Protection

Last but not least, weaknesses in real estate appraisal have also led to a negative impact in the protection of public interest. The State is the leading actor in the domestic real estate sector. In this context, central and local governments have extensive powers which affect the real estate market in a broader way. In this context sales, leases, establishment of servitude, privatisation of public properties,<sup>31</sup> expropriation,<sup>32</sup> contracts on build-operate-transfer or public private partnership (PPP) etc. are field which require real estate appraisal in Turkey. Taking into account negative public perception and the number (and impact) of lawsuits in the Turkish courts related to the above type of transactions, I argue that the management of public properties requires a better real estate management/appraisal framework. It is also important to note that the current central/local regulatory/supervisory structure is not sufficient to protect real estate consumers' rights.

The Capital Markets Board of Turkey has adopted international valuation standards as a domestic regulation in 2006.<sup>33</sup> Additionally, there is a regulated appraisal system in the banking/securities sectors. The real estate valuation companies are professional institutions which employ licensed valuers to determine the value of real estate, components of the real estate and real estate projects by gathering, analysing, and applying relevant information with respect to the generally accepted international principles of valuation.<sup>34</sup> While these developments can be accepted as good news for real estate

appraisal, there are still important deficiencies. First of all, above-mentioned regulatory framework cannot set down the standards for problems in the appraisal of public properties'. Second, although the regulation represents a significant step for the appraisal profession, to effectively implement the appraisal of real estate, knowledge of the market is of great importance and market players are expected to develop it. These include NGOs, SROs, regulators, academicians etc. Therefore, we would like to emphasise that real estate appraisal for public/market based transactions requires more sophisticated policies/practices.

## 4. A Model Suggestion: The Establishment of a Real Estate Regulation and Supervision Agency of Turkey (RERSAT)

Because the current regulatory/supervisory system has failed in solving specifically the problems of housing, land-use, urbanisation, real estate appraisal, protection of consumers/public benefit etc. in Turkey, there is a regulation rationale for the establishment of the Real Estate Regulation and Supervision Agency of Turkey (RERSAT) as a new government agency for real estate management.

We may analyse the rationale of the establishment of a new agency in the context of consumer/investor protection, enhancing co-ordination among different government agencies and enhancing the quality of appraisal.

### 4.1. Consumer and Investor Protection

The global financial crisis demonstrates the importance of co-ordination between financial regulatory authorities. It is observed specifically in the developed countries such as U.K., U.S, Germany, Holland etc. that real estate and the financial markets are interconnected. On the one side, it means positive externalities for both

<sup>26</sup> Apart from the Turk-Stat Housing and Rent Index (Mutluer, 2008: 258), there is no official or historically informative/broadly used rent and sales information in the real estate sector. It is important to note that Reidin, a private company, has published a housing sales/rent index since 2007 in Turkey (see, Reidin, 2010 and 2011). Apart from over optimistic market boom psychology, it would be possible to argue that current over supply in the residential and shopping center sub-markets in Turkey would be also related to a gap in information in the decision-making process arising from the absence of relevant statistics and price information.

<sup>27</sup> It can be useful to review European Mortgage Federation (2007: 121-141) relevant data to analyse the importance of the data problem in Turkish real estate market.

<sup>28</sup> On the other hand, it has been long observed that maturity mismatch is the leading factors causing increasing credit risks in the Turkish banking system. According to BRSA (2009: 30), although the capital adequacy ratio of the Turkish banking sector is 19,2% as of June 2009, deposit with maturities up to 3 months constitutes 92% of total deposits. IMF (2007: 6, 13) underlines that housing loans increase interest rate risks in banks due to duration mismatch.

<sup>29</sup> Deutsche Bank Research (2008: 23) indicates in relation to the Turkish market that with details of transactions remaining undisclosed there is a severe lack of information on deal flow.

<sup>30</sup> On the other hand, land shortage in the urban area and complexity of land use and zoning practices may also cause appraisal problems in real estate projects.

<sup>31</sup> Although foreign/domestic financial institutions provide advisory services to privatization transactions, there were many cases implying potential (firm/real estate) valuation problems.

<sup>32</sup> Keskin (2003) indicates that value of land may vary depends on the decision of the relevant valuation commission (namely, Value Appreciation Commission, Special Value Appreciation Commission or expert witness) in the process of expropriation.

<sup>33</sup> Serial VIII, No: 45 Communiqué on International Valuation Standards in the Capital Markets (see, <http://www.cmb.gov.tr/indexcont.aspx?action=showpage&menuid=1&pid=2>).

<sup>34</sup> See, <http://www.cmb.gov.tr/indexcont.aspx?action=showpage&showmenu=yes&menuid=4&pid=8&subid=2>, 16.04.2010.

housing finance and financial markets. But, as observed in crisis, this interconnectedness makes systemic risk management and the sustainability of housing finance more complicated. From the perspective of financial institutions, it seems that a consolidated regulator/single financial authority approach is a better solution to both consumer protection and systemic risk management. In this context, The U.S. Department of the Treasury (2008a: 169, 172) emphasises the importance of re-organisation in the mortgage/housing finance system. On the other hand, The Federal Geographic Data Committee (2009: 5,9) in regard to the U.S. underlines that local government land parcel level information is essential to the monitoring of the distressed housing market and that there is a need for a national system that can use early warning indicators of financially distressed housing and mortgage markets.

Current land parcel level information structure may not help in monitoring the trends of the mortgage market in Turkey due to a lack of institutional focus. Therefore, for better system wide risk management, the real estate sector needs a specific focus/ organisation on this issue. In the case of Turkey, instead of systemic concerns,<sup>35</sup> the rationale of re-organisation is related to protection of customers/public interest and also to increasing market efficiency (see, Table 4).

In the context of mortgage lending, the U.S. regulators established a brand new investor protection system based on Dodd-Frank Wall Street Reform and Consumer Protection Act (See, Davis Polk & Wardwell, 2010; Paulson, 2008; The U.S. Department of the Treasury, 2008a and 2008b).<sup>36</sup> In comparison to the developed markets, the Turkish mortgage market was underdeveloped in terms of financialisation, volume of securitisation, the use of complex financial products etc. In these circumstances, the coverage/scope of investor protection in the real estate sector should reflect the problems of the current market conditions.

Customer protection is at the centre of capital market regulation and also an important regulatory rationale in the banking and insurance sectors. Compared to the financial sub-sectors, there is little or no disclosure in the real estate market, particularly in residential and rural property transactions. Real estate transactions, mostly involving high amount of financial responsibility, may be complicated for average

households/investors having limited financial literacy. So, a less transparent market environment may not protect those unsophisticated households/investors.

This complicated market environment may be observed in house sales, real estate broker communications, mass-housing projects, land-use/development/renewal projects, housing cooperatives etc. This information asymmetry between buyer and seller (or their agents) does not support the interests of real estate consumers and there is no effective watchdog in the market who protects both sides of the transaction.<sup>37</sup> In particular, we think that inexperienced real estate consumers deserve a more transparent market to enable a healthier investment environment, not only in emerging markets, but also for the rest of the world. Therefore, because there is no well organised and effective customer protection in the Turkish real estate market, one of the critical responsibilities of the RERSAT is to protect real estate investors/customers. While developed countries may focus on mortgage market financial transactions/products in relation to customer protection, Turkey may need to particularly focus on real estate marketing/brokerage activities and non-institutionally financing real estate transactions due to characteristics of the domestic market.<sup>38</sup>

### 4.2. Enhancing Coordination and Protection of Public Interest

It seems that protecting public interest is relatively problematic due to its intensive political content and complicated structure. There are many central/local government authorities involved in the regulation/supervision of real estate business in Turkey. This structure is increasing inefficiency in private/public real estate management. For example, in the case of development rights, there are nearly twenty authorised public institutions in the Turkish legal system such as Housing Development Administration (HDA), Privatisation Administration, municipalities, National Estate Office, State Railways, The Ministry of Public Works and Settlement, The Ministry of Culture and Tourism etc.

As observed in many cases, it is difficult to protect the public interest through this complicated legal structure. Therefore it is expected that RERSAT would co-ordinate the authorised

government institutions' activities on real estate.

### 4.3. Better Valuation Framework

As reviewed in the previous section, the valuation requirement of public properties may arise from the transactions of public institutions (sale, lease, privatisation, expropriation etc.) or court decisions requiring real estate valuation. However each public property valuation case has its own merit, the system implies weaknesses. In this context, inadequate globally accepted professional knowledge<sup>39</sup> and absence of effective regulatory/supervisory framework are the components of increasing inefficiency. On the other hand, as noted above, market-based real estate valuations also need specific focus. To enhance the valuation profession and its regulatory/supervisory framework, we think that a common approach should be developed for both public and market based real estate transactions.

### 4.4. Goals and Benefits of RERSAT

To improve the business framework in public/market based real estate management, we think that RERSAT should be established as a new politically neutral independent central government agency. The goals (direct benefits) of the proposed new agency may be summarised as below.

As part of the above goals, it is expected that RERSAT may issue periodic reports on real estate sales/rent data, indexes and value-maps, oversee foreign real estate investments, issue reports on the major developments in the sector, and also publicly disclose the Agency's balance sheet, policies and practices. In this context, we anticipate that the activities of RERSAT may create positive externalities on urban/rural land policies and zoning/land-use practices.

There would be two important results from the establishment of RERSAT. First, it is believed that this framework would increase consumer protection, public interest and market efficiency, and hence the value of the Turkish real estate market. Second, the new government agency may enhance the effectiveness of public sector real estate management practices by co-ordinating the authorised government institutions based on the above objectives.

Discussion of the effectiveness of the HDA's current policies is beyond the scope of this paper.

<sup>35</sup> The Banking sector was the leading actor in the financial crisis in Turkey. In this context, Turkey has not experienced capital market and real estate originated financial crisis.

<sup>36</sup> Also see, [http://www.financialstability.gov/docs/regulatoryreform/strengthening\\_consumer\\_protection.pdf](http://www.financialstability.gov/docs/regulatoryreform/strengthening_consumer_protection.pdf) (28.04.2010).

<sup>37</sup> For principles for customer/investor protections in real estate markets, see United Nations (2010: 6-7).

<sup>38</sup> For interesting discussion on consumer protection in housing market see, Atterhöög (2005: 2).

<sup>39</sup> Public property valuers have no specific license recognized by the Capital Markets Board of Turkey or international organizations.



**Table 4: Principal Goals and Policy Instruments of RERSAT**

Principal Goals	Policy Instrument(s)
To enhance consumer/investor protection, public interest and market efficiency	- To issue regulations/standards for real estate brokerage/marketing/appraisal; public/private players' housing supply; land-use <sup>40</sup> ; development rights - To issue regulations/standards for housing finance - To enhance supervision on real estate (RE) transactions
To coordinate of the authorised central/local government agencies	- New regulatory framework for RERSAT and MoUs among authorised institutions - Simplifying, consolidating and converging rules/practices issued by different government agencies related to RE - Effective/politically neutral supervisory framework for land use/zoning practices
To promote fair market practices for housing market	- To issue regulations/standards for RE buying/selling activities - Better supervisory framework for public/market based housing transactions
To enhance transparency in RE price formation	- To enhance data availability (i.e. collect/publish data on RE sales/rent, publish official RE indexes etc.)
To enhance appraisal profession	- To develop policies/standards for public/ market based RE appraisals - To enhance supervision on appraisal firms' activities
To improve affordable housing	- To enhance primary/secondary mortgage markets through incentives - To transform HDA to a financial institution (i.e. Fannie Mae) and to create tax/insurance/credit incentives for the benefits of households and primary/secondary mortgage markets institutions
To improve policies on management of public properties, urban area land shortage and land speculation	- To develop transparent/politically neutral/accountable policies

Source: Author.

However the establishment of such a super authority inevitably brings into consideration of this discussion. Therefore, we would like to emphasize that RERSAT should specifically coordinate/supervise the policies of the HDA.<sup>41</sup>

To reach a more realistic approach, we have to underline the inadequacies of the suggestion of establishment of the RERSAT as the brand new central government agency. In this context, if public sector culture was prevalent in the RERSAT, the proposed agency could not fulfill expectations. Additionally, it does not seem sustainable to establish an effective real estate management system covering both public and private sectors unless the prerequisites, indicated in Table 3, have been met. It is also important to note that the idea of regulating/managing such a comprehensive organisational structure/market without any political influence seems too optimistic. At least, this suggestion may be helpful in any discussion of consumer protection, public interest and the market efficiency problems of the Turkish real estate market, to help formulate a new viewpoint.<sup>42</sup>

## 5. Conclusion

According to statistics, Turkey is one of the biggest economies in the world and also considered a promising country in the greater European region. As well as other immature sub-sectors, the real estate markets offer opportunities to investors. Although one side of the coin is bright for Turkey, the objective assessment of the domestic real estate market requires a cost – benefit analysis.

Fundamental instabilities, infrastructure problems, institutional deficiencies, irregular activities, inefficient finance-real estate linkage, appraisal problems for market/public based transactions, problems in land/cadastral information systems and problematic decision-making process of the public sector/judicial system can be classified as disadvantages. These factors are decreasing the visibility, transparency, expected rate of return, legal security and fair transaction opportunities in the Turkish economy/real estate market.

To improve the business framework in public/market based real estate management, we think

that a Real Estate Regulation and Supervision Agency of Turkey (RERSAT) should be established as a new, politically neutral, independent central government agency. There would be two important results of the establishment of RERSAT. First, it is believed that this framework would increase consumer protection, public interest and market efficiency, and hence the value of the Turkish real estate market. Second, the new government agency may enhance the effectiveness of the public sector real estate management practices by co-ordinating the authorised government institutions based on the above objectives.

The real estate sector seems extremely tied into local/central government policies and in the centre of the wealth accumulation process in Turkey. Therefore, we are clearly aware that there are important limitations on to which the above suggestion can be implemented. At least, we believe that this suggestion may be helpful in the discussion consumer protection, public interest and market efficiency problems of the Turkish real estate market, by putting forward a new viewpoint.

<sup>40</sup> An analysis for the principles for the benefits of integrated land administration system, see, United Nations (2010: 8).

<sup>41</sup> For detailed discussion and suggestions about the activities of HDA, see Coşkun (2011b: 17).

<sup>42</sup> Because of the scope of the paper, we may suggest further reading. To analyse problems and solutions framework, researchers may also review to those selected references. Üstünişik (1998),

State Planning Organisation (2001 and 2007), Yetgin and Lepkova (2007), Çete (2008), Akın (2009), Ministry of Public Works and Settlement (2009 and 2010). The Real Estate Regulatory Agency (RERA) of Dubai (see, [http://www.rera.gov.ae/rera/english/about\\_us.aspx](http://www.rera.gov.ae/rera/english/about_us.aspx)) and also state level regulatory agencies in the US also seem interesting to analyse as international experience (see, <http://www.arello.com/regulator/default.cfm>). On the other hand, United Nations (2010) and UN-Habitat (2008) would be useful international resources for best practice for land/real estate management.

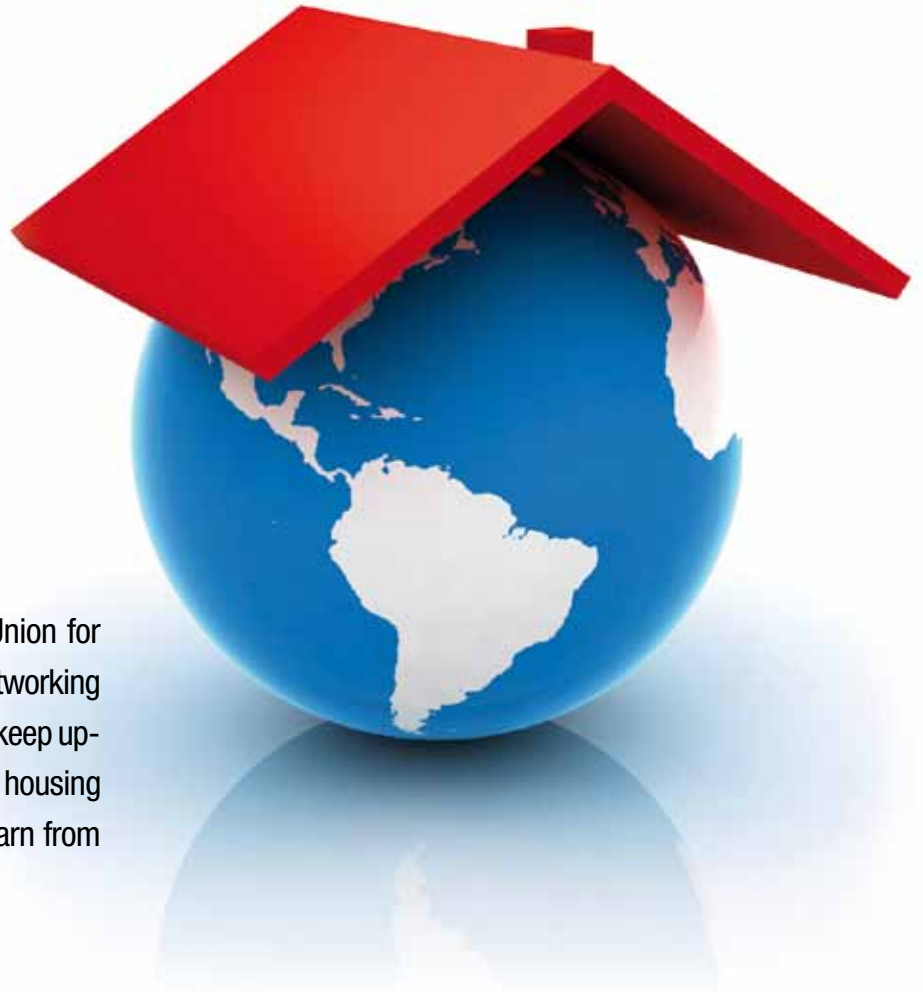
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