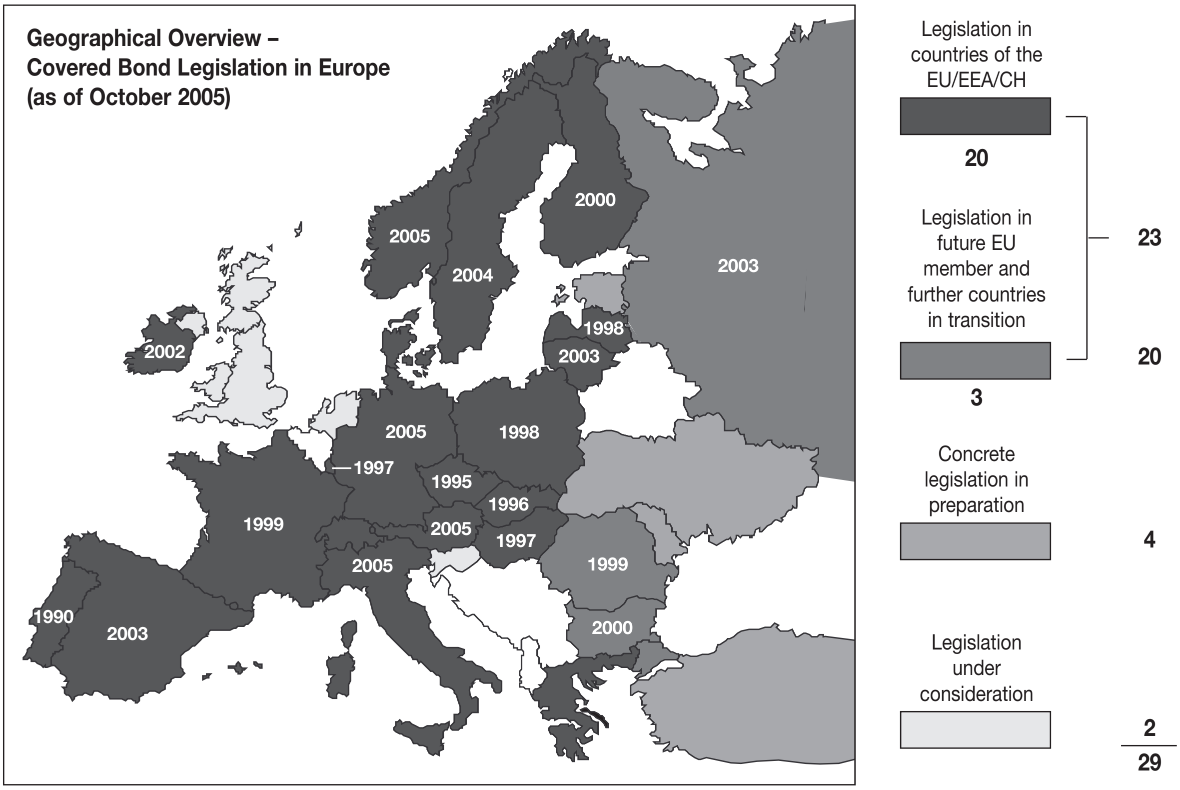
Specialization of Covered Bond Issuers in Europe

By Tim Lassen, previously a Lawyer at the Association of German Pfandbrief/Mortgage Banks

Today, the covered bond is Europe's most important non-state capital market instrument. By the end of 2004, the total volume of outstanding covered bonds amounted to EUR €1.6 billion, or 15 per cent of the European capital market.[1] In Europe, 30 countries have either introduced, or are considering introducing, legal provisions governing the issue of covered bonds (see illustration 1).

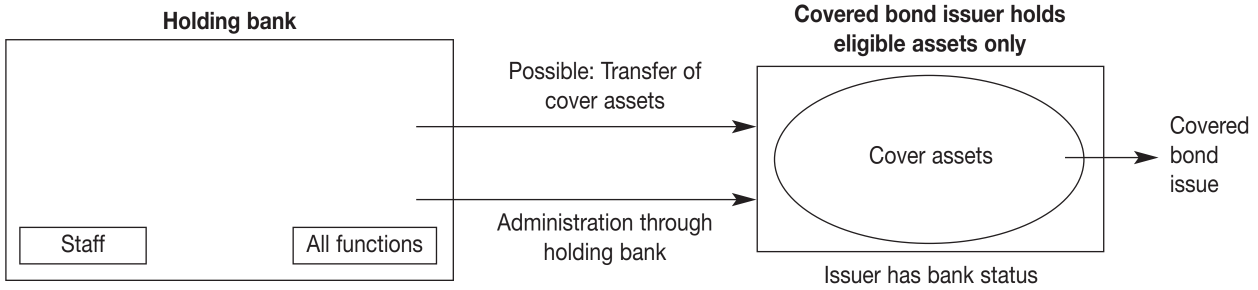
One question that always arises during discussions on the introduction of covered bond systems or their structures is that of the specialization required on the part of the issuer. The number of countries which prescribe specialization as a legal requirement and those that in principle give all financial institutions the right to issue covered bonds is almost equal, although the forms of specialization can differ considerably. The degree of specialization varies and even in those countries which do not have a specialist bank principle, not all

Illustration 1: Covered bond systems in Europe



[1] Source: European Mortgage Federation (www.hypo.org) and European Covered Bond Council (http://ecbc.hypo.org).

Illustration 2: Issuer as an issuance vehicle



banks are permitted to issue covered bonds without restriction.

This paper looks at the different types of specialization and, in the second half, outlines how under the new Pfandbrief Act of July 19, 2005 new Pfandbrief quality assurance regulations replace the 105 year-old specialist bank principle of the mortgage banks in Germany.

I. Covered Bonds Models with Different Types of Issuer Specialization[2]

Originally "specialization" meant restricting the range of business activities of Pfandbrief issuers to a small number of businesses with a low risk.[3] However, as legislation has developed in Europe, the original definition has moved on in recent years. In addition to restricting fully functioning financial institutions to specific fields of activity, the increasingly important matter of segregation of the cover pool in the event of insolvency and their transferability to other issuers has come to the fore.

These different approaches have in the meantime led to a wide range of different types of specialization in Europe, some of which are aimed at better protecting and isolating the cover funds under insolvency law, others at making the issuer bankruptcy remote, but most of which aim to do both. These forms of specialization and their advantages and disadvantages are described below.

The overview will start with the most highly specialized models and then explain the other structures which feature less specific specialization.

1. Issuers as Issuance Vehicles

This model is based on the concept of largely separating the issue of covered bonds from the generation of assets. This is carried out by splitting new business acquisition (origination) and the issue of covered bonds into two different legal bodies.

In this instance the issuer is only a funding vehicle, similar to an SPV, but does have a banking license and is subject to banking supervision. However, it has no employees of its own or other funds with which to operate a banking business. All functions are carried out by the parent bank. The

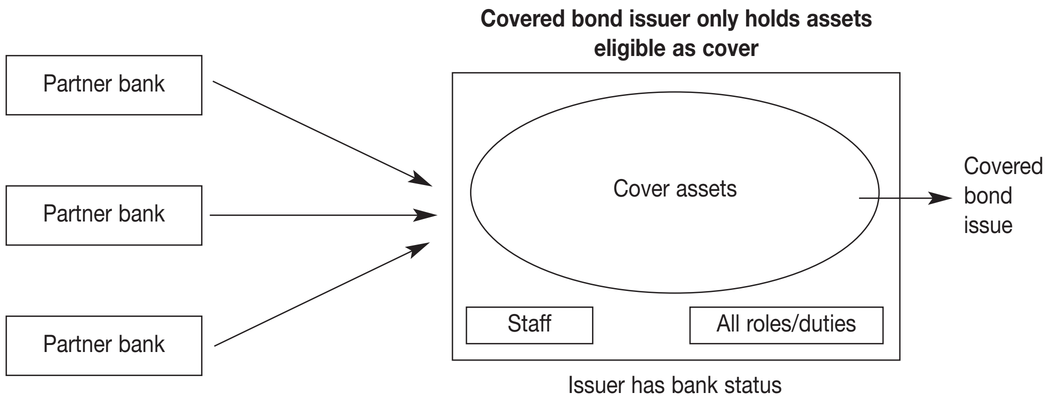
Table 1. Advantages and disadvantages of the issuer as an issuance vehicle

Advantages	Disadvantages
• High degree of specialization • Easy to supervise • Straightforward separation of funds in the event of insolvency • Low costs	• In actual fact a "mixed bank" with a legally separate cover pool in the event of insolvency • Parent bank is not a specialist in → typical mortgage bank business processes because of being a universal bank → the development of a low risk culture

[2] See also Jahresbericht des Verbandes deutscher Hypothekenbanken (Deutsch) 2004, p. 82 – 86; Nasarre-Aznar, Sergio/Stöcker, Otmar: Covered Bonds in Europe; in: de Vries Robbé, Jan Job/Ali, Paul U.: Securitisation of Derivatives and Alternative Asset Classes – Yearbook 2005, The Hague 2005, p. 167 – 206 (esp. p. 175 – 183)

[3] Source: Bellinger, Dieter/Kerl, Volkher: Hypothekenbankgesetz-Kommentar, 4. A. Munich 1995; Section 1 number 12

Illustration 3: Centralized issuer



subsidiary is restricted to accepting assets eligible as cover and funding them through covered bonds.

This model is used in France[4], Ireland[5], Finland[6], Norway (future)[7] and to a certain extent in Sweden[8].

2. Centralized Funding Institution

Centralized funding institutions[9] are used in Switzerland (Pfandbriefbank[10] and Pfandbriefzentrale[11]), Austria (Pfandbriefstelle[12]) and France (Caisse de Refinancement de l'Habitat, CRH). In Austria and France, these institutions exist alongside other covered bond issuers.

The member banks sell or pledge their mortgage loans to the centralized institutions, which in turn issue covered bonds for funding purposes. In Austria, the members themselves can also issue Pfandbriefe, whilst in Switzerland they may not.[13]

Table 2. Advantages and disadvantages of a centralized issuer

Advantages	Disadvantages
• Low costs • Employees are risk aware • Bigger issues	• Monopoly • Political influence • Co-operation between competitors: – business secrecy – strategy and structure of terms and conditions

4 Source: Kälberer, Wolfgang: Das französische Gesetz über die Sociétés de Crédit Foncier; Der langfristige Kredit 1999, p. 634 - 637

5 Source: Jahresbericht des Verbandes deutscher Hypothekenbanken (Deutsch) 2002, p. 80 f.

6 Source: Stöcker, Otmar: Das neue Hypothekenbankgesetz in Finnland; Der langfristige Kredit 2000, p. 544 - 546

7 Source: Lassen, Tim: Neue Regelungen zum Pfandbrief und zu Hypothekenbanken in Norwegen; Immobilie & Finanzierung 2004, p. 48 – 52
The new Norwegian law is scheduled to come into force at the end of 2005.

8 The Swedish law came into force on July 1, 2004. Covered bonds previously issued by Swedish mortgage banks must be converted into covered bonds under the new legislation, if the new issues should be done according to this new law, see: Stöcker, Otmar: Neues Gesetz über Covered Bonds in Schweden; Immobilie & Finanzierung 2005, p. 301 - 305

9 The question of the state's participation in a centralized funding institution is commented on in a separate paper.

10 www.pfandbriefbank.ch

11 www.pfanbriefzentrale.ch

12 www.pfandbriefstelle.at; see also Lassen, Tim: Pfandbriefe und fundierte Schuldverschreibungen in Österreich, Immobilien & Finanzierung 2005, p. 374 – 381, especially p. 377)

13 It is important to note that Swiss legislation has created two centralized institutions for reasons of competition and that neither receives a state guarantee or other public subsidies. They are not owned by the state, but by the partner banks they fund.

3. Specialist Bank With/Without Low Volume of Non-Cover Business

This model is based on the classic specialist bank principle, ie the issuer must limit itself exclusively or primarily to cover business. Traditionally this principle has been used to protect covered bond creditors as it aims to reduce the risk of the issuer becoming insolvent since the issuer only operates, or operates primarily, in particularly secure mortgage business. The mortgage banks can, but do not have to, work with partner banks in their lending operations or be part of a banking group.

This model is used in Denmark[14], Poland[15], Hungary[16], Luxembourg[17] and to a certain extent in Sweden. Until July 19, 2005 this was also the statutory model in Germany.

Illustration 4: Specialist bank with/without low volume of non-cover business

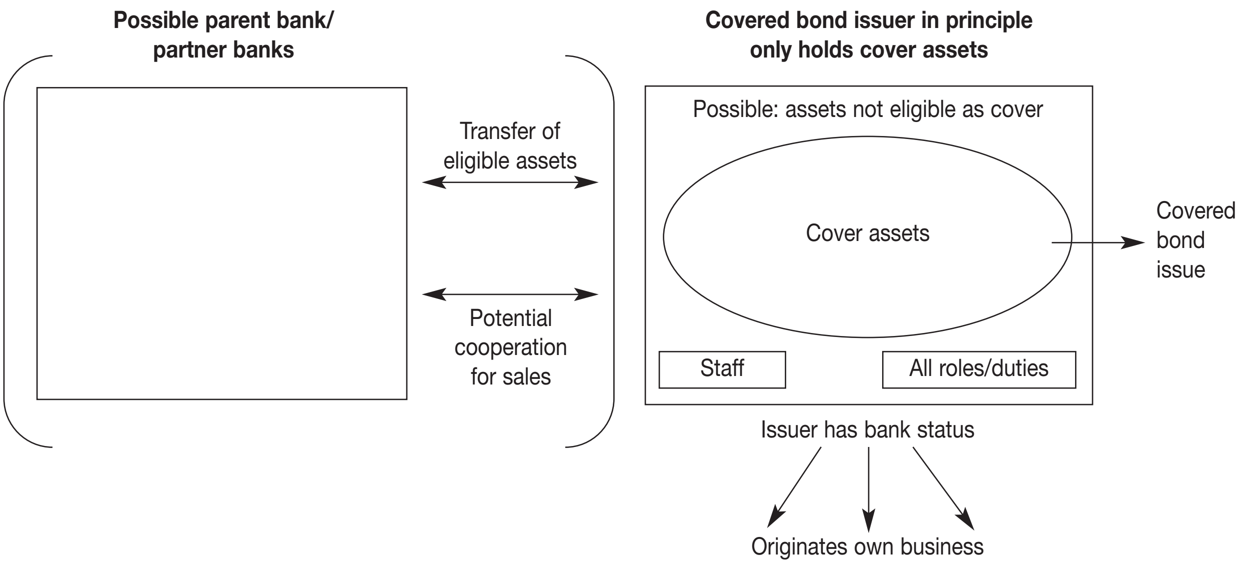


Table 3. Advantages and disadvantages of a specialist bank with outsourced administration

Advantages	Disadvantages
• Specialization on core business • Employees are risk aware • Low costs due to specialization of work flows • Easy to supervise • Issuer can decide which assets are included in the cover pool – therefore own asset/liability management	• Generation of business, inclusion in overall group, parent bank strategy • Problems with income generation ("resort to risk?")

[14] Source: Gjede, Torben/Blume-Jensen, Lars/Pedersen, Mette-Saaby: Denmark; in: European Mortgage Federation: Mortgage Banks and Mortgage Bond in Europe, 4. A. Brussels 2003, p. 67 - 78

[15] Source: Stöcker, Otmar:
– Das neue Hypothekenbankgesetz in Polen; Der Langfristige Kredit 1997, p. 650 – 655
– Die Novelle des Hypothekenbankgesetzes in Polen; Immobilie & Finanzierung 2002, p. 575 - 577

[16] Source: Neubauer, Peter/Stöcker, Otmar: Neues Hypothekenbankgesetz in Ungarn; Der langfristige Kredit 1997, p. 483 - 485

[17] Source: Stöcker, Otmar: Das neue Hypothekenbankgesetz in Luxemburg; Der langfristige Kredit 1997, p. 780 - 782

4. Universal Bank with Qualified Covered Bond License [FR2]

This is the structure used today in Latvia[18] and Russia[19]. It also became the statutory model in Germany[20] on July 19, 2005. Corresponding legislation is also being prepared in Slovenia. This model is based on the universal bank principle. Each bank wishing to issue covered bonds must qualify to do so and fulfill certain requirements. Whereas model 1 describes specialized banks, this model also refers to universal banks which are entitled to be granted a license for the issuance of covered mortgage bonds.

Illustration 5: Universal bank with qualified covered bond license

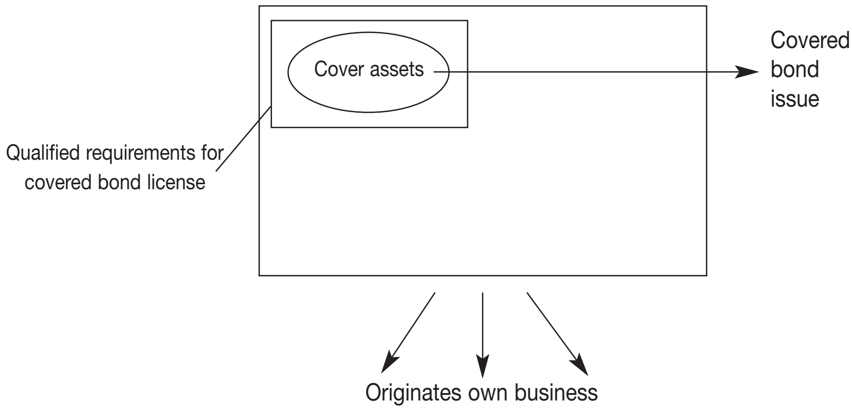


Table 4. Advantages and disadvantages of a specialist bank with qualified covered bond license

Advantages	Disadvantages
• No need to establish new, specialized banks; open to all lenders • Issuance right limited to a few stable issuers • May kick off higher volumes of standardized mortgages • May lead to lower prices for mortgage loans since more banks can stick to this funding instrument. Supply of funds increase.	• Higher risk at beginning until the necessary covered bond expertise has been developed at the universal banks • Difficult to avoid “opportunistic issues” • Hard to create a joint commitment on the part of the issuers for covered bonds and their further development[21] • May disadvantage existing holders at the start of covered bond issues (insolvency law: “cherry picking” in favor of the cover funds) • The less covered bond issuers are legally specialised, the more and detailed regulations their covered bonds need in order to achieve clear segregation and bankruptcy remoteness and to convince capital markets of it

[18] Source: Stöcker, Otmar: Neues Gesetz über Hypothekenpfandbriefe in Lettland; Der langfristige Kredit 2000, p. 55 f.
Lassen, Tim: Änderungen im lettischen Hypothekenpfandbriefgesetz; Immobilie und Finanzierung 2004, p. 189 - 191

[19] Source: Dëmushkina, Yekatarina:
– Opredeleniye pravogo statusa ipotecnoy cennoy bumagi; Rynok cennykh bumag (RCB), No 24 (255) 2003, p. 32 – 39
– Konceptual'nye pochody k opredeleniju pravogo statusa ipotecnoy cennoy bumagi; RCB No 1-2 (256 – 257) 2004, p. 67 - 72
Lassen, Tim: Wiedereinführung Pfandbrief-ähnlicher Wertpapiere in Russland; Immobilie und Finanzierung 2004, p. 120 – 124
No license is required in Russia, but an issuer permit linked to central bank requirements is needed for each issue.

[20] Representatively: Hagen, Louis: A new Era for the Pfandbrief; in: Association of German Mortgage Banks: Der Pfandbrief; 9th ed. Berlin 2004, p. 12 - 18

[21] One suitable instrument for creating this type of commitment between non-specialist banks is a joint lobby group. This lobby group would serve as the catalyst for the further development of the covered bond market and legislation as well as as a joint platform for discussions between the issuers and other market players (eg rating agencies) and a centralized representative body in dealings with the regulatory authorities and legislator.

Examples of such groups are the Association of German Pfandbrief Banks (www.pfandbrief.de) which represents all German Pfandbrief issuers and the establishment of a specialist association of mortgage securities issuers planned by the Moscow Mortgage Agency, Delta Credit and Gorodskoj Ipotetetschnyj Bank.

Other specialist assocations in the mortgage financing sector in Europe are the Association of Danish Mortgage Banks (www.realkreditraadet.dk), the Mortgage Credit Foundation in Poland (www.fukrehip.pl), the Association of Hungarian Mortgage Banks (www.mortgagebank.hu), the Ukrainian National Mortgage Association (www.unia.com.ua) and at European level, the European Mortgage Federation (www.hypo.org) and under its auspices the specialist lobby group for covered bonds, the European Covered Bond Council (http://ecbc.hypo.org).

5. Issue Permit for all Banks without Licensing or Licenses without Requirements

Under this model, all banks can issue covered bonds without the issuance right being linked to any requirements. This is the case in Spain[22], the Czech Republic, Lithuania[23] and Bulgaria[24]. A license is necessary to issue covered bonds in Slovakia, but this is awarded upon request without the need to fulfill any requirements.

Illustration 6. Structure of a universal bank that issues covered bonds without the need for a license

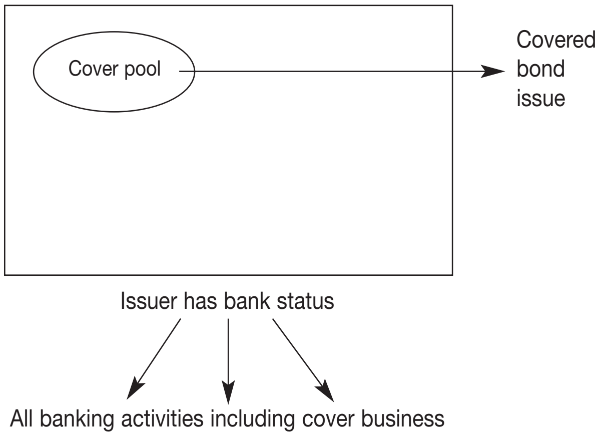


Table 5. Advantages and disadvantages of a universal bank without a covered bond license

Advantages	Disadvantages
• Large volume of outstanding covered bonds quickly built up • A large number of issues • No time-intensive establishment of specialist banks	• No “covered bond” specialization by issuers • Opportunistic issues • No, or problematic, development of a covered bond market, low level of interest in further development of the covered bond as an instrument. The banks are not linked to it, they don’t have to do any effort to obtain any license. If they have some eligible assets, they can issue covered bonds – or not do it. • No, or problematic, development of a joint lobby by covered bond issuers and its further development (commitment). Commitment can not develop, if the banks are not linked to the product. • May disadvantage existing holders at the start of covered bond issues (insolvency law: “cherry picking” in favor of the cover funds) • In some cases security for covered bonds achieved by high level of excess cover (e.g. Spain: 11% for mortgage covered bonds; 31% for public covered bonds) • Ring fencing difficult: ratio of covered bond creditors to unsecured creditors (e.g. depositors) • The less covered bond issuers are legally specialised, the more and detailed regulations their covered bonds need in order to achieve clear segregation and bankruptcy remoteness and to convince capital markets of it

[22] Source: Nasarre Aznar, Sergio: La garantía de los valores hipotecarios; Madrid – Barcelona 2003

[23] Source: Lassen, Tim: Neues Pfandbriefgesetz in Litauen; Immobilie und Finanzierung 2005, p. 91 - 93

[24] Source: Lassen, Tim: Hypothekenobligationen in Bulgarien; Immobilien & Finanzierung 2004, p. 542 - 545

8. Summary and Policy Issues

There is no unequivocal answer to the question of whether or not specialization is necessary. To a large extent it depends on the structures already in place, market conditions and the relevant objectives. In a market dominated by strong universal banks it will be rather difficult to introduce specialized banks. If the banking sector is in an early stage of development, without dominating banks and the mortgage sector is starting to develop, it will be easier to implement specialized institutions as a link between mortgage market and capital markets.

If the legislator wishes to make a clear decision regarding the necessary degree of specialization, then the following policy issues should be clarified first:

a. Supervision
- Efficiency and intensity of supervision
- LTV limits for funding through covered bonds
- Security through institutional barriers or through over-collateralisation

b. Risk Management
- Responsibility for risk management and asset/liability management
- Risk awareness on the part of the issuer
- Issuer free to decide which assets it includes in the cover pool?
- Issuer to generate assets itself or function purely as a funding vehicle?
- Dependency of specialist bank on parent bank
- Question of priority for issuer's creditors
- "Ring fencing": Relation between covered bond creditors to unsecured creditors (eg depositors)
- Issuer's other creditors may be disadvantaged by the inclusion of the covered bond issue (depositors, debentures with pari-passu or negative pledge clauses)

d. Market and Sustainability
- Product diversification of the issuer
- Avoidance of opportunistic issues – need for sustainability of issues
- Issuers committed to establishing and developing a covered bond market

e. Profitability
- Cost of establishing a specialized issuer
- Diversification of earnings
- Operational costs of originator and issuer
- Volume of business eligible as cover in national market

II. Introduction of the New Pfandbrief Act in Germany

Specialization offers certain advantages to issuers and above all to Pfandbrief investors, including, in particular, specialization of work flows (and the associated higher level of quality), ring fencing and security in the event of insolvency, whereby creditors are protected from third party access to the cover pool (e.g. by depositors or other creditors).

Nevertheless – as shown above – the introduction of non-specialist institutions for mortgage lending and covered bond issues is often difficult due to political reasons or market structures.

Other precautions therefore have to be taken to achieve the quality assurance effects of the specialist bank principle, namely

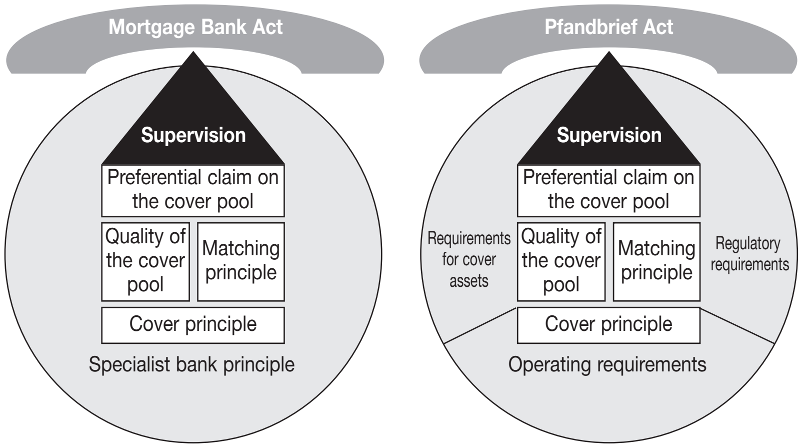
- the joint commitment of the mortgage banks to the quality of the Pfandbrief, in particular through voluntary measures and the further development of the legal framework (Pfandbrief commitment),
- a high degree of homogeneity of the issuers as a requirement for a transparent and liquid market, and
- enhancing the security of the Pfandbrief.

Special statutory regulations on quality assurance and detailed provisions to ensure the preferential right in the case of insolvency of Pfandbrief holders are essential, if these aims are to be achieved within a universal bank system. The new German Pfandbrief Act, which came into force on July 19, 2005, is an example of these measures as outlined below.

Another decisive point for securing investors is the regulation on the preferential right in the event of insolvency (see 2 below).

Illustration 7: Difference between Mortgage Bank Act and new Pfandbrief Act

Until July 18, 2005



After July 18, 2005

Illustration 8: Structure of the Pfandbrief Act

Structure of the Pfandbrief Act

Regulatory requirements
- Specific licensing for Pfandbriefe under certain circumstances
- Sanctions imposed by BaFin

Operating requirements
- Sustained Pfandbriefe issues
- Professional risk management
- Improved transparency
- Expertise of managers

Requirements for cover assets
- Claims on public financial institutions without state guarantees not eligible as cover
- Specification of LTV calculation provisions

Quality assurance measures

- Cover principle
- Matching principle
- Preferential right of Pfandbrief creditor in the event of insolvency
- Statutory surplus cover of 2% (incl. stress scenarios)
- High quality requirements for cover pool
  – conservative valuation
  – 60% LTV
- Special statutory supervision (BaFin)
- Independent trustees
- Preferential right of Pfandbrief creditor in the event of insolvency
- Clear contingency plan in the event of insolvency; administrator

Policies in Mortgage Bank Act

1. Quality Assurance Measures

a. Regulatory Requirements

- Requirement for a special Pfandbrief license

Not all German financial institutions automatically have the right to issue Pfandbriefe. Those institutions wishing to issue Pfandbriefe have to apply to the German Federal Financial Supervisory Authority (BaFin[25]) for the relevant license. This license may only be granted, if the institution complies with statutory requirements including a minimum tier 1 capital of €25 million, a business plan showing that the financial institution can operate its Pfandbrief business on a regular and sustained basis and that the necessary organizational structure is in place. In addition, the organizational structure and resources of the financial institution must take appropriate account of future Pfandbrief issues and the associated lending activities (real estate, public finance and/or shipping finance).

If these requirements are fulfilled the license will be granted. No permits are required from BaFin for individual issues.

- Express regulation on particular supervision of all requirements under the new Act

A key feature of the security of the German Pfandbriefe is the particular supervision by BaFin in addition to general banking supervision to ensure strict compliance with the statutory requirements. This is highlighted once again and regulated in even more detail in the Pfandbrief Act whereby BaFin is in future obliged to check the cover pool every two years as a rule.

- BaFin is authorized to transfer the cover pool and Pfandbriefe to another Pfandbrief issuer.

Previously, the cover pool could only be transferred in the event of the issuer becoming insolvent. The Pfandbrief Act allows BaFin to additionally revoke the Pfandbrief license, if the Pfandbrief bank no longer complies with the license requirements or has not issued any Pfandbriefe for two years and does not intend to do so within the next six months. If the license is revoked or expires, BaFin

[25] www.bafin.de, in Germany the supervision of banks, insurance companies and the securities markets is carried out by BaFin – the German Federal Financial Supervisory Authority.

can apply to the courts to appoint an cover administrator, whose rights are based on the regulations for a cover administrators in the event of the issuer's insolvency.

b. Operating Requirements

The operating requirements for Pfandbrief issuers replace the specialist bank principle, that was the mechanism regulating the financial institution as a whole. Consequently, only the management of the cover pool is subject to specific requirements, as this is the guarantee that the claims of Pfandbrief holders can be settled in the event of the issuer becoming insolvent.

- Professional risk management of cover pool

One precondition is that the Pfandbrief bank has suitable risk management systems to actively manage credit risk, cluster risk, market risk and liquidity risks relating to the cover pool. This also ensures that the issuer has to operate its Pfandbrief business in a sustained and non-opportunistic manner if it wants to amortize the necessary investment.

- Evidence of expertise in Pfandbrief issues and cover transactions

The Act requires that Pfandbrief banks possess specific expertise in the business fields in which the cover pool is generated, as well as in the management of specific risks. This requirement refers not only to systems but also to the employees of the issuer.

- Stricter transparency regulations especially regarding disclosure of the cover pool

The new transparency regulations under the Pfandbrief Act are based on the requirements of rating agencies and analysts of those Pfandbrief issuers which already have had to fulfill the requirements of the ratings agencies. This enables investors to judge the quality of the cover pool for themselves in terms of credit quality, regional diversification and volume. This leads to a disciplined approach which enhances the prescribed professional risk management.

c. Cover Asset Requirements

- Mortgage lending value calculation

The regulations governing the mortgage lending value calculation have been revised and clarified. Care has been taken to ensure that these regulations comply with today's accepted standards.

- State liability

It is now clear in the regulations that being a public sector institution is not sufficient on its own to make the assets of a public Pfandbrief eligible as cover and state liability is required instead.

2. Preferential Right for Covered Bond Creditors in the Event of Insolvency

One of the fundamental features of the covered bond is its preferential right in the event of the issuer becoming insolvent. The covered bond creditors have a prior right on the cover assets included in the cover pool.

a. European Legal Provisions

A preferential right in the event of insolvency is also stipulated in Article 22 (4) of the UCITS directive, which regulates the easing of supervisory requirements in the financial industry and sets a minimum standard for covered bonds in the EU for investors.

According to Article 22 (4), the cover assets must be specified as prior ranking by law for repayments of capital and interest in the event of a loss of the issuer. There must be no direct relationship between the covered debentures, which the financial institution issues and reports on the liabilities side of the balance sheet, and the cover assets, as long as the financial institution operates. Only if the issuer becomes insolvent does the true legal nature of the covered bonds (Pfandbriefe) come to light: the covered bond holder has a preferential right to satisfaction of his claim in the event of insolvency or a preferential lien with a comparable financial outcome. Creditors other than the covered bond holder may not enforce their claims on the cover pool. Only the covered bond creditors are entitled to a lien on the cover assets. Capital and interest must be serviced from the cover assets without them becoming part of the general bankrupt estate.[26]

However, the UCITS directive does not specify how the preferential right in the event of insolvency is to be structured.

b. Policy issues to be regulated

In principle, the less a covered bond issuer is required to specialize by law, the more precise the regulations must be to ensure a separation of the cover pool and bankruptcy remoteness, as well as timely payment of the covered bonds.

This preferential right is secured in different ways in the various covered bond systems in Europe.[27] Internationally, high demands are placed on the bankruptcy remoteness of covered bonds as complied with by new legislation in Ireland, France, Poland, Germany and most recently Russia.

Key points in today's European debate are:

- In case of insolvency of the issuer, the cover pool is managed by a court appointed administrator, as separate as possible from the insolvency administrator of the general insolvent assets of the issuer.

[26] Source: Bellinger, Dieter: Commentary on Art. 22 (4) of the UCITS-directive; in: European Mortgage Federation (publ.): Mortgage Banks and Mortgage Bonds in Europe; 3rd ed. Baden-Baden 2001; Point 4.13.2

[27] See the detailed questionnaire and the answers to Austria, Germany, Italy and Lithuania: www.pfandbrief.de – Pfandbrief – Covered bond legislation – Central European covered bond conferences – IX. Central European covered bond conference, Budapest 2005 – First Panel (Moderation: Dr. Otmar Stöcker)

- The management costs are financed by the surplus cover. In the event of the covered bond issuer becoming insolvent, the surplus cover must not be surrendered immediately.

- The provision of the option of transferring the assets entered in the mortgage register to another bank together with the covered bonds liabilities.

- Especially, the timely payment of the covered bonds has to be ensured.

The aim of a covered bond regulation is to secure the investors from any default of covered bonds. One possibility is to specialise the issuers on secure types of businesses like mortgage lending – but like eg the French model shows, this can be done in a way that leads to a type of a mixed bank – but on the other hand with a very clear structure in case of bankruptcy.

The main discussion today therefore should no longer be about a question of specialization (that can't be achieved due to many political or economic reasons), but about the way to secure investors as far as possible from the default of the issuer – by allowing issuance only to banks fulfilling special requirements and by detailed regulation of the preference right in case of bankruptcy.

On Truly Privatizing Fannie Mae and Freddie Mac: Why It's Important and How To Do It

By Lawrence J. White, Professor of Economics at Stern School of Business
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I. Introduction

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are the two extremely large companies that are at the center of the residential mortgage finance system of the United States. They are similar in size, function, purpose — and controversy. Two years ago Freddie Mac experienced major accounting problems that eventually led to a wholesale change of top management. A year ago fall Fannie Mae experienced major accounting problems that led also to a wholesale change of its top management.

The controversies that surround these two organizations are not accidental. Their special hybrid (quasi-governmental) form, large sizes, rapid recent growth rates, and dominance of residential mortgage finance have placed them in the policy spotlight, and this public scrutiny is unlikely to disappear any time soon.

The focus of the current policy attention that is being paid to these two companies is largely centered on reforming the regulatory structure and processes that surround them. But these reform efforts are, at best, a second-best approach. Instead, a better policy focus would be to remove all of the quasi-governmental features that make the two companies special — ie, truly privatizing them. Thus, the goal would be to allow them to function as effectively as their inherent organizational strengths and skills would permit – but without any of the special quasi-governmental features that give them special advantages as compared with other companies.

This paper will offer the reasons why this goal is worthwhile and a straightforward way that it can be achieved.[1] Section II provides a brief review of Fannie Mae and Freddie Mac and their special features. Section III will outline the major policy problems that follow from their special status. Section IV will offer a straightforward plan for privatizing the two companies.

II. Fannie and Freddie: A Brief Overview

Fannie Mae and Freddie Mac are the fourth and fifth largest companies in the U.S., when measured by assets, as of the end of 2004. They each operate two related lines of business: They issue and guarantee mortgage-backed securities (MBS) that have residential mortgages as their underlying assets, and they invest directly in residential mortgage assets. The latter investments are funded overwhelmingly by debt. Their growth rates in the 1990s and in the early years of the current decade were especially breathtaking (although growth in 2004 slowed considerably for both companies). As was mentioned in the Introduction, these rapid growth rates and their current very large sizes are major sources of the two companies' current prominent position in the public policy spotlight.

A. Their special features and advantages.

Fannie Mae and Freddie Mac are not ordinary corporations. Though they are owned by shareholders and their shares of stock are traded on the New York Stock Exchange, they have an array of connections with the federal government that make them quite special:

– They were created by Acts of Congress and thus hold special federal charters (unlike virtually all other corporations, which hold charters granted by a state, often Delaware).

– The President of the United States can appoint 5 of the 18 board members of each company.[2]

[1] This paper draws heavily on White (2003, 2004) and Frame and White (2004, 2005). Further details, summaries of the controversies, and back-up references for the points and arguments that are developed in this paper can be found in those studies. An earlier version of this paper was presented at a conference on "Fixing the Housing Finance System," Wharton School, University of Pennsylvania, April 27, 2005.

[2] In 2004 the Bush Administration ceased appointing those board members.

– The Secretary of the Treasury is authorized to purchase up to $2.25 billion of each of their debt liabilities.[3]

– They are exempt from all state and local income taxes.

– They can use the Federal Reserve as their fiscal agent.

– Their debt is eligible for use as collateral for public deposits, for purchase by the Federal Reserve in open-market operations, and for unlimited investment by federally insured depository institutions (ie, commercial banks and saving and loan associations [S&Ls or thrifts]).

– Their securities are exempt from the Securities and Exchange Commission's registration and reporting requirements and fees.[4]

– Their securities are explicitly government securities under the Securities Exchange Act of 1934.

– Their securities are exempt from the provisions of many state investor protection laws.

– They are exempt from bankruptcy law, and no receivership provisions apply, so that in the event that they were to experience financial difficulties and could not satisfy all financial claims made upon them, only the Congress could resolve the situation.

B. Some disadvantages.

The two companies are also subject to substantial restrictions:

– Their special charters restrict them to residential finance.

– They are explicitly forbidden to engage in mortgage origination.

– They are subject to a maximum size of mortgage (which is linked to an annual index of housing prices) that they can finance; ie, a maximum value for a mortgage that can be the basis for issuing MBS or purchased for holding in their portfolios. For 2005, that maximum (which is described as the "conforming loan" limit) is $359,650.

– The mortgages that they finance must have at least a 20% down payment (ie, a maximum loan-to-value ratio of 80%) or a credit enhancement (such as mortgage insurance).

– They are subject to safety-and-soundness regulation by the Office of Federal Housing Enterprise Oversight (OFHEO), which is located within the Department of Housing and Urban Development (HUD).

– They are subject to "mission oversight" by HUD, which approves specific housing finance programs and sets social housing targets for the two companies.

C. The immediate consequences

The special features of the two companies have created an aura or "halo" around the two companies, often summarized in the phrase "government-sponsored enterprises" (GSEs) that is used to describe them and a few other organizations that embody similar perceptions of extensive federal government entanglements with a nominally private organization. Consequently, the financial markets have come to believe that the federal government would likely "bail out" the companies – and thus their creditors – in the event that either experienced financial difficulties – even though their charters and each security that they issue state explicitly that these companies' obligations are not obligations of the federal government.

Nevertheless, this perception of a likely bailout has persisted and has come to be called the belief in an "implicit guarantee."[7] An immediate consequence is that the two companies are able to borrow funds at rates that are better than those of corporations that are rated AAA, though not quite as good as the rates at which the US Treasury borrows, even though the companies' ratings on a stand-alone basis (which would ignore the likely government support) would be only AA-. This favorable borrowing possibility translates empirically into approximately a 35-40 basis point advantage on their direct corporate debt and about a 30 basis point advantage on their MBS issuances. Since the two companies are highly leveraged – supporting their assets plus MBS through 96-97% debt and only 3-4% equity — the consequences of this borrowing advantage are substantial.

In turn, the companies pass most – but not all – of their borrowing advantages through to residential mortgage borrowers. The interest rates on conforming loan mortgages are about 20-25 basis points lower than the rates on otherwise similar "jumbo" mortgages that are above the size limit for conforming mortgages.

3 This is often paraphrased as their having a potential line of credit with the Treasury.

4 In 2002, in an effort to quell criticism and fend off legislative action, the two companies "voluntarily" announced their intention to adhere to the SEC's reporting requirements. Thus far, only Fannie Mae has actually registered its equity securities.

5 One important reflection – and reinforcement – of that halo is the way that financial information (eg, current prices and yields) about the two companies' debt obligations are listed in financial publications. The Wall Street Journal, for example, lists this information in a special box that is labeled "Government Agency & Special Issues" and that is often located next to its listings of Treasury debt obligations (and usually on a different page from its listings of corporate debt obligations).

6 Most notable among these other GSEs are the Federal Home Loan Bank (FHLB) system and the Farm Credit System.

7 Recent discussions by the credit rating agencies in justifying the AAA ratings that they have assigned to the debt of the two companies have been explicit in their description of their belief in a high likelihood of a federal bailout and thus of an implicit guarantee. This belief is supported by the history of the federal government's implicit forbearance when Fannie Mae was insolvent on a market-value basis in the late 1970s and early 1980s and the government's explicit bailout (with taxpayer funds) of another GSE, the Farm Credit System, in the late 1980s.

D. Some additional consequences.

Because Fannie Mae and Freddie Mac were able to operate nationally at a time when other mortgage lenders were geographically constrained, they were able historically to bring a greater degree of uniformity and stability to residential mortgage financial markets that otherwise would have been localized and disconnected. Further, their size and stature may have been important in allowing them to serve as focal points for the adoption of standards with respect to technological advances in the processes of mortgage origination. And though neither was the pioneer in the issuance of MBS – that role was played by Ginnie Mae in 1970 – Freddie Mac was a fast second in 1971. There is little question that the special GSE status of the two companies helped establish MBS as a worthwhile alternative financing channel alongside the more traditional channel of the portfolio lender.

III. The Problems

A. Housing Issues

The encouragement for housing purchase and consumption that Fannie Mae and Freddie Mac provide are not an isolated policy foray. Instead, these two companies and their effects are part of a far larger mosaic of policies at all levels of government to encourage greater construction and consumption of housing – the most notable of which are the income tax treatment of mortgage interest and property taxes on personal residences[8] and the exemption from capital gains taxes of all or most of the capital gains on residences.

There are sound "positive externalities" arguments (supported by a growing empirical literature) for encouraging home ownership: for example, a home-owning household is more likely to care about its neighborhood than is a renting household. Such arguments would argue for modest, focused programs that would be in the form of explicit subsidies for down payments and/or monthly payments for low- and moderate-income families that would not otherwise be homeowners and are thereby induced to become first-time buyers.

Unfortunately, instead of modest, focused programs, housing public policy has embraced broad-brush, unfocused approaches that mostly encourage households that otherwise would buy anyway simply to buy larger and better appointed homes on larger plots of land. As a consequence, the US economy has invested excessively in housing and insufficiently in other forms of physical and human capital.

The encouragement for home ownership that is provided through the special status of Fannie Mae and Freddie Mac – the 20-25 basis point reduction in mortgage interest rates – is of this same broad-brush nature, with the same unfortunate consequences.[9] Further, the conforming loan limit is *far above* the size of the mortgage that could be used to purchase the median price home in the US.[10] For example, in 2003 the conforming loan limit was $322,700. In that year, the median price of a new home that was sold in the US was $195,000, and an 80% mortgage on that home would have been only $159,080. Also in that year, the median price of an existing home that was sold in the US was $170,000, and an 80% mortgage on that home would have been only $136,000.

As a consequence, the two companies' efforts are not focused on encouraging low- and moderate-income households to become first-time home buyers. Despite HUD-set targets for such activity, which the companies have met, recent evidence gathered by HUD (in support of more ambitious targets) indicates that Fannie Mae and Freddie Mac have lagged the overall market in providing mortgage finance to this segment.[11]

In sum, US housing policy in general and Fannie Mae's and Freddie Mac's activities in specific have failed to focus on the true positive externalities from home ownership and have simply encouraged the construction and consumption of too much housing in the U.S. economy. "Too much is never enough" is not a sensible basis for public policy.

B. Safety and Soundness.

A recent policy focus has been on the safety-and-soundness regulation to which Fannie Mae and Freddie Mac are subject. Since the financial markets believe that the federal government would bail out the two companies and since this belief seems likely to become reality in the event of the companies' financial difficulties,[12] the federal government has a legitimate interest in trying to ensure the solvency of the two companies – although (ironically) the presence of effective safety-and-soundness regulation may strengthen the financial market's perception that the federal

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[8] Ie, these expenses can be deducted from gross reported income, but the implicit rent of an owner-occupier is not included in income.

[9] Also, the reduction in mortgage interest rates is fundamentally a subsidy for borrowing. Thus, a household can refinance a home with a larger mortgage (which is a frequent occurrence at times of falling interest rates) and thereby take greater advantage of the subsidy. But such actions do not affect the rate of home ownership

[10] The conforming loan limit is 50% higher for homes purchased in Alaska, Hawaii, and the US Virgin Islands, and it is higher for two-unit, three-unit, and four unit-residences (all of which are considered "single-family" homes) and for multi-family rental housing.

[11] This evidence is part of the regulatory analysis underlying HUD's decision in November 2004 to set more ambitious goals. See http://www.hud.gov/offices/hsg/gse/gse.cfm. The Bush Administration's federal budget documents for fiscal years 2005 and 2006 offer brief summaries of this evidence. See USOMB (2004, 2005).

[12] Though senior federal officials have (only in the past few years) begun denying the existence of any "implicit guaranty", they have yet to state explicitly that they would not bail out either company in the event of financial difficulties.

government would bail out the two companies.

Only in 1992 did the federal government explicitly recognize this interest by creating OFHEO and empowering it with safety-and-soundness authority.[13] Nevertheless, until it challenged Fannie Mae's accounting practices in September 2004, OFHEO was perceived politically as a weak regulatory agency with inadequate regulatory powers and weak political effectiveness in Congress (as compared with, for example, the bank regulatory agencies).[14]

The Congress held hearings on regulatory reform in 2003, 2004, and 2005 but was unable to pass legislation that would be agreeable to the Bush Administration.[15] The perceived weakened political positions of Fannie Mae and Freddie Mac (because of their respective accounting difficulties) have increased the likelihood that some measure of reform will be signed into law in 2006.

C. Systemic risk.

The large sizes of Fannie Mae and Freddie Mac, their focus on a narrow class (residential mortgage) of assets, their relative importance in the area of residential mortgages, and their relatively high leverage and relatively low capital levels (3-4% of assets) has recently generated a debate concerning systemic risk – ie, the consequences for the rest of the economy if either of them were to experience financial difficulties.

These concerns extend beyond just the losses that the two companies' creditors would experience in the event of the two companies' financial difficulties. Rather, systemic risk issues focus on one or both of the following: (1) a fear that there would be a cascading effect because the losses experienced by the companies' creditors would be so severe as to cause those companies to become bankrupt or insolvent, in turn causing further waves of financial losses and failures; or (2) a fear that the financial difficulties of either company could substantially affect the residential mortgage markets, with further adverse consequences for home buyers and sellers, realtors, home builders, etc.

The issue of systemic risk is linked inexorably to the issue of safety and soundness. Systemic risk is one potential justification for safety-and-soundness regulation. To the extent that safety-and-soundness regulation[16] is adequately ensuring the solvency of the regulated institutions, systemic risk concerns should be diminished.

It is no accident, then, that the systemic risk issues with respect to Fannie Mae and Freddie Mac arose at roughly the same time as the concerns about the inadequacy of OFHEO's safety-and-soundness regulation of the two companies. And, if the safety-and-soundness issues outlined above are adequately addressed in legislation, the systemic risk concerns that surround the two companies should similarly diminish.

Nevertheless, because safety-and-soundness regulation will never be perfect, and because there are only the two large and prominent GSEs at the center of the secondary mortgage finance system, some systemic risk concerns are likely to persist.

D. The absence of prepay penalties and the bearing of interest-rate risk.

The standard residential mortgage in the U.S. is a 30-year fixed-rate debt instrument on which the borrower can prepay at any time with no penalty. The absence of an explicitly priced prepay option for the borrower means that the lender bears all of the interest-rate risk of these instruments. This additional risk for the lender causes mortgage interest rates to be higher than if a prepay option were explicitly priced. There is a resulting net benefit for those who do indeed prepay their mortgages (eg, who refinance them when interest rates fall below the levels that prevailed when the original mortgage was issued) and a net cost for those who do not prepay; in essence, the latter are cross-subsidizing the former.

Why don't the mortgage markets offer borrowers the choice of a lower interest rate if they accept a prepay penalty or a higher interest rate if they want the "free" prepay option? A patchwork of laws that forbid prepay penalties in some states seems to be part of the answer. But another part seems to be the policies of Fannie Mae and Freddie Mac, who generally buy or securitize only mortgages that do not have prepay penalties.

E. Possible efficiencies or inefficiencies.

Because of the two companies' special status and favorable borrowing rates, it is extremely difficult to determine how much of their current size and prominence (or of any proposed horizontal or vertical expansionary initiative) is due to the inherent efficiencies of their portfolio and

[13] Calls for explicit safety-and-soundness regulation of the two GSEs had, of course, preceded the legislation that created OFHEO. See, for example, Moe and Stanton (1989) and Stanton (1990, 1991).

[14] For example, OFHEO took almost 10 years to establish and implement the risk-based capital requirements for Fannie Mae and Freddie Mac that were mandated in OFHEO's enabling 1992 legislation. And, most important in the current environment, it lacks the authority to establish a receivership in the event of financial difficulties for either company, and it lacks the authority to modify the minimum capital requirements that apply to the two companies.

[15] Besides issues of regulatory authority, including the crucial issue of receivership powers, other points of dispute have included whether the regulatory agency should stay in HUD; if not, whether it should be moved to the Treasury (and if so, how much direct oversight the Secretary of the Treasury would have over the agency) or whether it should be moved outside the executive branch entirely and established as a separate "independent" agency; whether the regulation of the FHLB system should be consolidated into whatever regulatory agency emerges or whether that system's regulator (the Federal Housing Finance Board) should remain intact; and how the agency should finance its activities.

[16] It has been one of the traditional justifications for the safety-and-soundness regulation of depository institutions.

MBS operations and how much is due to that special status and those favorable borrowing rates. Without a "clean" market test, a definitive answer is likely never to be known.

IV. True Privatization as the Solution, and How to Do It

A. True privatization as the solution.

As was discussed in Section II, Fannie Mae and Freddie Mac are nominally "private" companies. But as that Section also described, they embody an array of special features that cause them better to be described as GSEs rather than as purely private entities. And, as Section III discussed, their GSE status creates or contributes to an array of serious problems.

Though regulatory reform is currently the topic for policy debate, such reform is, at best, a second-best solution. Instead, true privatization of the two companies[17] – ie, the withdrawal of their special Congressional charters and all of the special features that go with those charters – is the best solution.[18] Figuratively, public policy should shake the hands and pat the backs of the senior managements of the two companies (and their predecessors for the past three decades), praise them and tell them "job well done" (for helping bring about the securitization revolution), and point them toward the Delaware Secretary of State's office in Dover for their new corporate charters. The goal would not be to destroy or remove the companies from the marketplace but instead to allow them to compete in the marketplace on their own true merits (and without their special quasi-governmental status and advantages).[19] Faced with the withdrawal of their special federal charters, the two companies would indeed likely seek Delaware charters and hope to become "ordinary" Delaware companies – albeit initially quite big ones but also, importantly, subject to the normal bankruptcy laws. To the greatest extent possible they should be allowed to do so. At the Congressional hearings that would precede the passage of any privatization legislation, the Secretary of the Treasury should loudly proclaim that (after privatization) the Treasury will treat the two companies no differently than it does other corporations in the US economy and would trust to the bankruptcy courts to deal with any financial difficulties. Similarly, the President should reiterate that message at the official signing of the legislation.

Along with the withdrawal of their special Congressional charters and attendant features ought to be the withdrawal of safety-and-soundness regulation of the two companies and of any special HUD oversight or Community Reinvestment Act-like requirements. Market forces, supplemented by explicit federal subsidies to low- and moderate-income households who are first-time home buyers, should prevail.

Although the financial markets might initially believe that the two companies' large sizes would mean that the companies were "too big to fail" (ie, that in the event of financial difficulties the federal government would bail them out anyway), the markets would surely be less certain of this position than they currently are with respect to the implicit guarantee. The borrowing costs of the two companies would rise – perhaps by as much as the 40 basis point differential that accompanies current beliefs.[20] With a smaller cost advantage, their presence in the conforming residential mortgage segment – as investors and as securitizers – would surely diminish. But also, without the conforming loan limit and the statutory 20% down payment, they would be free to enter jumbo lending and sub-prime mortgages, as well as other areas of consumer finance where their lending expertise might be valued. But with true privatization there would be a market test for their presence. And the size and variety of the other market participants would make it unlikely that "predatory" behavior (in the antitrust sense of initially cutting prices below marginal costs, in the hopes of gaining an eventual monopoly) would be worthwhile or attempted. It is this author's guess that the net effect would be a shrinkage in the asset sizes of the two companies.

With the increase in their borrowing costs, it is likely that the interest rates on conforming residential mortgages would increase – by perhaps as much as 25 basis points. This would be a relatively modest increase – one that (in nominal terms) the mortgage markets accommodate frequently. Such an increase would be all to the good, as it would reduce the overall level of the broad-brush subsidy provided to housing. In place of the GSEs' special status, the federal government should expand its on-budget programs to encourage home ownership by low- and moderate-income households.

If the two companies' sizes do shrink after they become Delaware corporations, concerns about "too big to fail", their systemic risk,[21] and the concomitant need for safety-and-soundness regulation would diminish. Further, their diminished role in the mortgage markets would increase the likelihood that the prepay option would be

[17] It is interesting to note that the legislation that created OFHEO in 1992 also called for a set of studies on privatizing the GSEs, which were eventually published in 1996. See USHUD (1996).

[18] As a related policy matter, if Fannie Mae and Freddie Mac are truly privatized, then the FHLB system also should be truly privatized.

[19] Arguably, some of their current systems and organizational efficiencies were developed with the help of their special advantages of the past. Nevertheless, any effort to try to recapture these advantages would be an unnecessary diversion from the important goal of removing their special advantages going-forward and would risk the elimination of real efficiencies.

[20] Alternatively, they would have to raise more (costly) capital to reassure their creditors that the two companies' relatively low borrowing rates were justified; or some combination of higher capital levels and higher borrowing costs.

[21] Also, since depositories tend to be highly leveraged, as their holdings of Fannie Mae and Freddie Mac straight debt securities diminish, concerns about cascading effects should diminish.

priced explicitly. Finally, with the implicit guarantee gone, their activities in any sector would meet a market test.

In sum, true privatization would address all of the concerns raised in Section III.

B. How to do it.

The best way to achieve true privatization is to follow the Nike Corporation's admonition: Just do it!

This change of policy would most directly affect those who bought Fannie Mae's and Freddie Mac's securities believing in the "implicit guarantee". Public policy owes such purchasers no special favors and no special transition, since they have been warned explicitly that the GSEs' obligations were not those of the federal government and nevertheless have chosen to ignore that information. Indeed, to establish special transition rules[22] would be to reward those who ignored the warnings – roughly similar to rewarding those who build houses on flood plains, despite warnings not to do so, and who are then bailed out by Congress.

But what of potential sharp disruptions to the residential mortgage market? The simple answer is that there are unlikely to be sharp disruptions. First, the magnitude of the changes in the prices of the companies' outstanding debt are unlikely to be large. Recall that the two companies' special borrowing advantage is about 40 basis points. The removal of their special status would cause the financial markets to discount the expected payment streams on their existing debt by (at most) an additional amount that would equal those same 40 basis points. This change is well within the kinds of fluctuations that the financial markets deal with frequently. For example, for a 10-year 5% straight bond, a 40 basis point increase in the discount rate that is applied to the bond's payment stream would mean a decline in the bond's price by approximately 3%. More generally, if the average duration of the liabilities of the two companies is about 5 years and their average interest expense on those liabilities is 4%, the average price decline over all of those liabilities would be about 2%.

Second, and at least as important, the privatization process would *not* be the equivalent of a sudden bankruptcy filing. Any changes – small or large – in prices in the mortgage markets would be gradual and transitional. After all, any privatization would occur in a highly political environment and would not be sprung on the markets overnight.

One possible scenario would unfold as follows: The administration would announce its intentions to seek true privatization legislation – or, perhaps, announce its intentions to appoint a task force to recommend legislation. Subsequently, legislation would be introduced in Congress. Congressional hearings would be held. Majority votes of both houses of Congress would eventually occur, and the President would then sign the legislation. Progress would thus be incremental, with the market participants' gradually adjusting their estimates of the likelihood that true privatization would prevail. The prices of the two companies' securities would change incrementally, with relatively small losses or gains occurring at any point in time.

C. Second-best.

Despite its superiority in dealing with the real problems raised by the special status of Fannie Mae and Freddie Mac and its straightforward simplicity, true privatization is an unlikely prospect for the immediate future. Their recent accounting stumbles notwithstanding, Fannie Mae and Freddie Mac and their roles in broadly encouraging housing construction and consumption still enjoy widespread political support on Capitol Hill.

Consequently, second-best policies must be considered. These should consist of: improved safety-and-soundness regulation (which must, at its heart, embody a market-value accounting framework), enforced by a regulatory agency that is lodged in the Treasury and that has receivership powers; the adoption by bank and S&L regulators of the standard loans-to-one-borrower limits on the two GSEs' straight debt obligations; the freezing of the conforming loan limit at its current level of $359,650, which would force the two companies gradually to focus more of their efforts on the lower end of the market, where the positive social externalities of home ownership are the strongest;[23] the maintenance of HUD's pressure on the two companies to focus more of their efforts on the lower end of the market; and the repeated statements by the Secretary of the Treasury and other senior officials of every administration that the federal government means what it says on every GSE security and that they have no intention of ever "bailing out" either company or its creditors.

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[22] As was done for the privatization of Sallie Mae (see Dean, Moskowitz, and Cipriani [1999] and Overend [2001]) and as has been advocated for Fannie Mae and Freddie Mac by Ely (2004) and Wallison, Stanton, and Ely (2004).

[23] A freeze of the conforming loan value is a far superior method for limiting their size and growth, as compared to a simple cap on their assets or on their borrowing. A freeze would gradually but directly force them to focus on the lower end of the mortgage market, where the positive social externalities are the greatest. A cap on their size (assets or borrowing) would instead cause them to focus more on the upper end of the mortgage market, where their margins (for any given size) would likely be higher, unless HUD's "mission regulation" forces them farther into the lower end.

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Bausparkassen and Globalisation

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Introduction

The Federal Republic of Germany is facing radical changes, which are emerging at many levels and which have already seriously altered or will still further alter life in Germany. These modifications are not taking place abruptly, but more gradually as an ongoing process. This is especially true of the population trend and the age structure, the frontiers of economic growth, the fundamental budgetary difficulties of the public authorities, the associated problems of the social security systems and finally the change of an industrial society into a services society occurring as part of the process of globalisation.

The Bausparkassen

With the change, people too are adapting in respect of both the supply of, and the demand for, goods. In turn, this means that financial services institutions, and especially the Bausparkassen, have a massive need to adapt: from single product producer to member of a group of suppliers with a differentiated product range.

The Bausparkassen were founded after the First World War – in the mid-1920s – a period characterised by lack of housing on a massive scale, unemployment, high inflation and a collapse of the market for junior mortgages. A clear division of labour very quickly emerged in the ensuing years between first-ranking financing by banks and savings banks and second and lower-ranking financing by Bausparkassen, which was very successful and continued even after the Second World War, when Germany was again facing huge reconstruction and integration problems. In this respect, a decisive role was played by the fact that the Bausparkassen on the one hand ensured sufficient equity capital formation through the accumulation of savings deposits and on the other hand made loans available at very favourable interest rates which were independent of the capital market.

This link ultimately ensured that housing finance, and especially the financing of owner-occupied housing, has been relatively continuous and stable in Germany in the past decades, whereas in many other countries there have been very sharp fluctuations to be observed in new construction and so on the financing side too.

The German Bausparkassen can therefore also boast an extremely successful balance sheet: since the end of the war, they have been involved in the financing of well over 13 million dwellings. During this period, they have paid out over €900 billion for new buildings, existing housing, modernisation and renovation work, etc. In the past 10 years alone, between three and four million new building loan contracts per year have been concluded on savings of €70 to 80 billion and sometimes even more.[1] At present, the German Bausparkassen manage 33 million contracts of some 25 million members on total savings of over €720 billion.

Through these services, the Bausparkassen have contributed substantially to the current relatively satisfactory housing supply situation and the largely balanced housing markets in Germany, although the public authorities have always focused aid on housing for rent.

The Role of the State and Demographic Change

With the growing demand being met over the years, certain regulatory principles developed in housing policy, which were of far-reaching importance for housing finance, although some of them were not implemented to the necessary extent by the politicians. For instance, public aid should in principle play only a subsidiary role. This applied in particular for the acquisition of owner-occupied housing with tax incentives pursuant to § 7 b and later § 10 e of the Income Tax Act, through which it was intended to mobilise "self-help" on the part of house-hunters. For many years, far too little account was taken of this principle, which has only come to the fore again recently – in view of empty government coffers.

In the coming years, fundamental changes to the general conditions are to be expected, which will be accompanied by substantial effects on the housing markets and housing policy. The State can no longer play the role of universal "provider". The social services can no longer be maintained on the old scale because the number of "beneficiaries" of the social security system is constantly rising and the number of contributors currently declining. The individual will have to look after himself and provide for his own future to a considerably

[1] One reason for the renaissance of the bauspar product in Germany was the stock market crash in the late 1990s. German savers sought safe investment possibilities and bausparen was considered one of them.

greater extent than before. This is particularly applicable in view of the shifts in the age structure of the population. Authoritative experts[2] agree that although the number of German inhabitants will remain more or less constant in the next 20 years and the number of households relevant for housing construction will rise further by about one to two million, there has already been a distinct rise in the age ratio for years. Whereas in the mid-1990s there were only 37 German citizens of over 60 years of age to 100 German citizens of working age of 20 to 60 years, this figure is currently already 45 and will rise to 56 in the year 2020. Two workers will then already have to support more than one pensioner. This means drastically rising social insurance contributions or correspondingly higher self-provision.

Furthermore a similar trend is to be seen not only in Germany, but also in all other industrialised countries. Sweden, for example, has the largest proportion of over 65 year-olds (of the total population) at 17.5%, followed by Italy with 16.8%, Belgium with 16.0% and the United Kingdom and Germany with 15.7% each. Spain, France and Austria too are above the 15% threshold. In the coming years, this age ratio will rise in all countries – in some cases drastically. By the year 2020, every one in five inhabitants in Europe will be 65 years of age and over.

In parallel to the ageing of the population, the typical (German) house-building family, the married couple with two small children, as traditional target group of the Bausparkassen, is increasingly becoming a dying breed. The proportion of single-person households has risen considerably in recent years. The birth rate is extremely low.

The Impact on Financial Services

Not least as a consequence of this clearly emerging demographic trend, the financial services market – as for that matter the markets in other economic sectors too – is fighting considerably harder. The keener competition, as a result of the market entry of foreign institutions (eg Citibank or ING Bank), so-called “near banks” and direct banking, has certainly also contributed to this.

Greater market transparency and growing customer demands have led to an increasing forfeiture of margin and commission and to rising pressure to rationalise in the credit industry, which has also not left the Bausparkassen unscathed. Competition compels ever larger units in order to be able to cut costs and to hold one’s own in international competition. Cooperation agreements, mergers and amalgamations are the consequence. The number of savings banks has fallen in recent years from over 700 to under 500 now, the cooperative institutions have nearly halved in number from nearly two and a half thousand to 1,300. The number of Bausparkassen has fallen from 34 in 1998 to 26 institutions today.

In addition to this, the formerly clear frontiers between bank and insurance products are becoming increasingly blurred. Whereas hitherto the focus was on the opening up of new sales channels, in recent years especially – not least with a view to private pension provision – competition has erupted on the product side. This has led to new financial groups coming into existence. In view of the order of magnitude of these financial conglomerates, some of which have already reached the international sector, there is still quite some pent-up demand on the German market. This field will play a key role in the significance of property assets and housing finance.

The Bausparkassen are therefore not only in competition with one another, but increasingly also in competition with other suppliers of construction financing and pension products and notably other finance distribution organisations (eg assurance companies, banks and state savings banks). In the meantime, the inclusion of all Bausparkassen in groups or networks has been the consequence.[3]

According to the findings of the Deutsche Bundesbank,[4] efficiency gains through the exploitation of advantages of scale and networks have increased the “risk-bearing capacity of the financial conglomerates”. For example, in this way, cross-selling activities have contributed to the income position of Bausparkassen which are incorporated in such financial conglomerates being better in the past seven years than in the other Bausparkassen. On the other hand, there are also examples of efficiency gains through synergy effects not occurring, or not to the extent hoped for. Hence changes of strategy are to be observed in the credit industry too: participating interests held by banks in insurance undertakings are sold and instead contractual cooperation agreements entered into. Moreover, the greater readiness of customers to change their behaviour, increasingly observed for some time, has resulted in “one-stop shop” concepts being reconsidered and a reversion to the “core competence” being brought to bear.

Furthermore, not least, cost considerations have resulted in outsourcing certain processes from the actual field of activity of the Bausparkassen, ie the withdrawal of business processes, such as the establishment of so-called “credit works”, which can deal with large numbers of loans using standardised procedures – not only for their own customers. Also in the field of data processing, the development of new IT systems, purchasing or in building management, specialists are taking on the work for them.

New Markets for Bausparkassen

The opening up of new markets abroad has also contributed to the further growth and

[2] Reports and statistics released by the Statitische Bundesamt and Bundesamt für Raumwesen und Raumordnung.

[3] For example this ist he case of the Wüstenrot Bausparkasse AG which is a subsidiary of the Wüstenrot & Württembergische Group.

[4] German Bundesbank, monthly report, Nr. 4/2005.

success of the Bausparkassen. Whereas before the fall of the iron curtain, German Bausparkassen committed themselves and offered building loan contracts or housing finance mainly in the Western European neighbouring States – especially in the border areas with Belgium, the Netherlands, Luxembourg and France – they expanded their business activities after 1990 to Central and Eastern Europe.

Already before German reunification, saving for home ownership was introduced in 1990 in what was still the former GDR. The introduction met with an extremely large response among citizens and as a whole can be considered an extraordinary success.[5] This rapid success was primarily attributable to the fact that institutions established for many years in West Germany could transfer their distribution system to East Germany at very short notice. In this way, a comprehensive supply of building loan contracts was provided very rapidly. The financial services of the Bausparkassen not least contributed to new housing construction activity in East Germany, which had come almost entirely to a standstill after the period from 1990 to 1992, being cranked up very quickly and on a quite considerable scale. Other groups of institutions made housing finance loans available only very hesitantly, because from their point of view, the corresponding collateral provided by borrowers was insufficient or because they were not interested in smaller scale financing, especially for modernisation and renovation work.

Two years later, in 1992, saving for home ownership was introduced in Slovakia according to the German model. Two Bausparkassen were set up under joint venture agreements, which so far have been operating very successfully on the market.

In 1993 followed the introduction of saving for home ownership in the Czech Republic. Here too, the German institutions work in joint ventures with domestic institutions. Saving for home ownership has rapidly become established as a very popular saving and financing instrument. Two in every three Czechs today have a building loan contract.

In Hungary too, saving for home ownership has become an essential component of housing finance since 1997. Two institutions are currently working there.

In Croatia, and recently in Romania too, building loan contracts, according to the German model and with German participation, have been offered to the institutions. Bausparkassen are even active and extremely successful in China and India. At present, investigations are being carried out in Bulgaria and Kazakhstan to see whether these States offer potential to be able to establish saving for home ownership there too.

In New Zealand, the introduction of a so-called "Kiwi Saver" system is planned, which closely resembles the building for home ownership system: firstly own capital must be saved before a loan is received. A State premium is given as an incentive to saving. In contrast to the German (collective) system, corresponding contracts can be concluded here with all credit institutions; this is therefore an open saving for home ownership system, similar to that existing in France.

It is of great importance in the countries mentioned that saving for home ownership increases the chance to acquire ownership especially for lower and middle income groups and offers an opportunity to finance the constantly growing demand for housing and housing modernisation.

The Changing Role of Bausparkassen

Globalisation has caused very rapid acceleration of the direct networking of the various national capital markets into a single capital market. Monetary policy is scarcely controlled at all any more by the individual central banks, but is under the pressure of worldwide "vagabonding" of capital flows which, thanks to the electronic media, can be moved round in fractions of a second to make extra profit. The massive stock market boom with the ensuing heavy crash at the turn of the millennium was only one indicator of this trend, which ultimately has also led to the capital market interest rate currently reaching record lows – and not only in Germany – because large volumes of capital are in search of investment opportunities.[6]

The Bausparkassen, with their traditionally low, but agreement-tied, interest on loans, are particularly hard hit. Whereas 5% interest on loans was still unbeatably favourable up to the mid-1990s, because the long-term interest on capital market mortgages stood at 8.5%, mortgage rates today, even with a fixed period of several years, at about 4%, are not even half the previous level and are hence below those offered by the Bausparkassen.

The saving for home ownership institutions have taken account of this for some time by offering new rates with essentially lower interest on loans which have been lowered as far as 2%. In addition, nearly all institutions today offer a variety of rates or rate variants so that the customer can choose from a whole range of products. In some cases, the possibility even exists for members, even after concluding the contract, to make changes subsequently to the rate conditions if how they are going to use the loan changes. The rates on building for home ownership loans therefore offer a high degree of flexibility and variety today

[5] Success is measured in the achieved new business.

[6] A further reason is the nearly infinite pool of cheap labour in China that has pushed down prices of many goods world-wide, thus easing inflationary pressures in developed countries. This development allowed central banks to keep inflation rates low. The return on capital increased. The result has been a misallocation of capital, most obviously displayed at present in the shape of excessive mortgage borrowing and housing investment.

which allow a tailor-made product for the customer. With the extensive offer of different interest rates and different length saving and redemption periods, the modern building loan contracts offer optimum possibilities also to combine them with other property finance modules, such as bank and mortgage loans.

In contrast to many other suppliers on the property finance market in Germany, which provide for minimum limits for the granting of mortgages at €50,000 or €100,000, the Bausparkassen are specialists in the "micro" field. This will be to their advantage in the coming years if building new housing should play an increasingly less important role in housing finance as a whole. Demand will come increasingly from income groups, and especially too from smaller households, which cannot or do not wish to afford expensive properties because, for example, they (will) inherit a property. These target groups will focus on existing properties or carry out modernisation and renovation measures in the housing stock. In view of the age structure of the German housing stock, with an average age of nearly 50 years, and in view of a relatively high proportion of dwellings which were built in the 1950s and 1960s with very basic equipment, there is a huge demand for conversion and renovation. Bausparkassen should be the first choice precisely for such measures with a need for financing of between €20,000 and €50,000.

The property bubbles currently appearing in a whole series of countries, such as Spain, the United Kingdom and the USA, as a consequence of speculative sharp price rises could, should they burst, have serious consequences for both the property owners and the financing institutions. In most of these countries, the proportion of equity capital is infinitely small so falling prices lead very rapidly to forced sales because the risk buffer in the form of appropriate equity capitalisation is lacking. Such a development, as in the meantime is also viewed very critically by international organisations, such as the Bank for International Settlements or the OECD, could considerably boost as well the international position of the Bausparkassen and their products based on the formation of equity capital.

How to Boost Rental Housing Construction in CEE/SEE Countries

By Wolfgang Amann

Managing Director, Institute for Real Estate, Construction and Housing Ltd.

1 Introduction

Economic growth in central and south eastern European countries shows promising results. The growth rate of GDP for this region for 2005 and 2006 is expected to exceed the growth rate of the EU-15 members. As GDP growth in EU-15 will be 1.9% in 2005, for CEE, 3.6% and for SEE 4.8% is expected. For 2006 the forecasts are similar with 2.2% for EU-15, 4.1% for CEE and 5% for SEE.[1]

These positive results have also spilled over into the housing sector. All countries report an increase in mortgage loans and new construction of dwellings. However, rental housing construction and refurbishment of multi-storey panel buildings have not yet benefited from this trend. Although considerable action has been taken by the individual governments, progress in these two areas is still sluggish.

Within this framework, the Institute for Real Estate, Construction and Housing in Vienna (IIBW) is preparing a Feasibility Study on "A Housing Finance Agency (HFA) for Central Eastern and South Eastern European Countries". This study will be developed by an international team consisting of banking practitioners, experts in housing finance and housing policy. Financing partners are Austrian and international research funds as well as international commercial banks with market interests in CEE/SEE countries. A project advisory board is headed by Dr. Erhard Busek, the Special Coordinator of the Stability Pact for South Eastern Europe. Members are amongst others representatives from target countries, international organisations, development banks and commercial banks.

The study is based on the main hypothesis that insufficient rental housing construction is particularly due to lacking or ill-functioning financing instruments. The team examines different housing promotion schemes aimed at linking the potentials of national housing policy, international development banks to commercial banks and housing developers. The institution will be organised in form of a Public Private Partnership (PPP). It is viewed as a promising model to promote rental housing construction. Thus, the article will lay down the main objectives of this new institution and the expected benefits of its future work. It is expected that the Housing Finance Agency will be able to link promising housing developments to quality issues of the housing stock and adequate financing models in cooperation with public and international institutions and commercial banks. The feasibility study is likely to be completed in spring 2006.

2 Housing markets in CEE/SEE Countries

In the transition period, most CEE/SEE countries have actively encouraged homeownership by means of mass housing privatisation and the introduction of several subsidy programmes for housing. As a result, many countries have achieved high levels of home ownership (average of 68% of total occupied dwellings in CEE and above 80% in SEE countries) in comparison with EU15 (about 62 %) and the United States (approximately 67 %).[2] Data on rental housing are inconsistent, which is partly due to unclear classification. Graph 1 gives an overview about housing tenancy in selected CEE/SEE countries. Social renting is classified as public rental plus cooperative housing. Older publications show lower levels of rental housing, but higher shares of "others". This of course implies quite different conclusions.

Some Central European countries have kept a considerably high level of social rental dwellings, in particular municipal housing and rental dwellings of housing cooperatives. It is around one third of the housing stock in Czech Republic and Poland and still nearly 20% in Slovakia. Almost no social renting has remained in Hungary and Slovenia as well as in all SEE countries.

Due to economic constraints during the transition period, housing construction has decreased considerably. Only construction of single family houses has by and large not been affected. However, multi storey and particularly rental housing construction has come more or less to an end. This trend changed at the end of the nineties, when multi storey housing construction gradually recovered. Today overall construction rates

[1] WIIW (2005), IFC (2005).

[2] OECD (2005), PRC (2005).

in some CEE countries already come close to the EU 15 average although there are serious deficiencies:

- Housing in CEE/SEE is characterized by underinvestment for more than 15 years. Therefore a construction rate close to EU 15 average is far below the needs. Parts of the housing stock are in a state of disrepair. Replacement of these is indispensable in the medium-term.

- The allocation of flats in stock does not reflect demand. Economic changes have strengthened the metropolitan areas and weakened rural areas. There is an oversupply of housing in disadvantaged regions and a depressing shortage on housing markets in the metropolitan areas.

- The markets particularly produce condominiums for higher income segments. Even though a surprisingly high number of households is able to afford upscale condominiums, the specific demand of middle and lower income groups is not covered at all.

- There is still almost no rental housing construction.

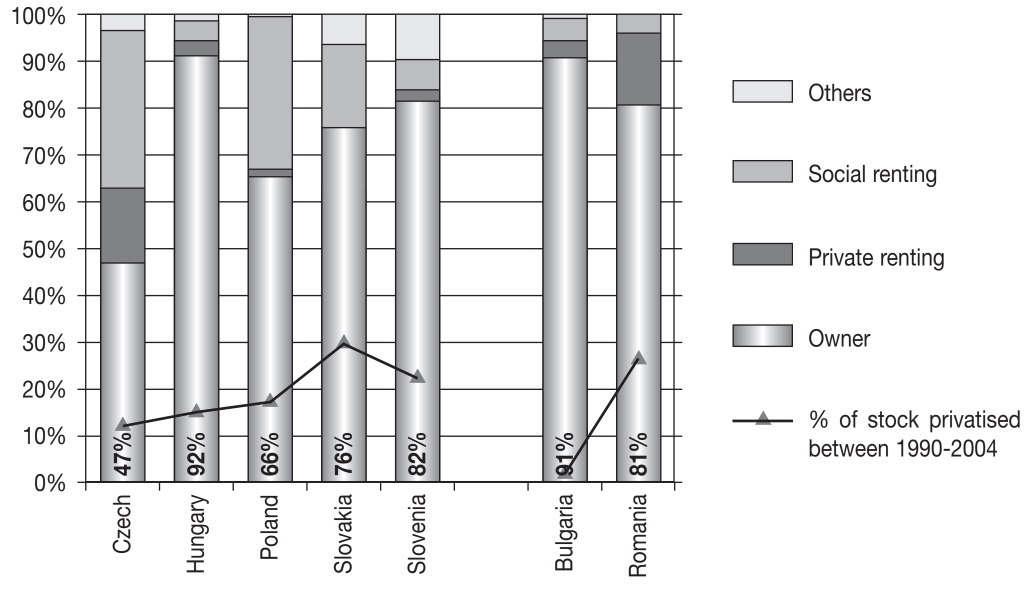
- The increase of construction output in some countries is strongly related to new housing subsidy schemes. A change of these models may cause serious decreases of construction output. This recently happened in Hungary

The average household size is 2.8 persons in CEE and 3.3 persons in SEE countries. The number varies only slightly in CEE from 2.6 persons in Hungary to 3 persons per household in Slovakia. Notably large households are found in Kosovo (5.6) and Albania (4.2). In other SEE countries the household size is below 3 (Bulgaria, Romania, Serbia). The useful floor space per capita is ca. 26m² in CEE countries and only 16m² in SEE countries.

The data for housing expenditure, ie the part of household incomes which has to be spent for housing, are inconsistent. Average household incomes in CEE countries are about €400 per month, in SEE countries €210 (in EU 15 it is €1,960). Following the data of PRC (2004) households in CEE countries have to spend on average €100 per month for housing, which results in a housing expenditure rate of 25.4%, a level slightly above EU 15 average. For the future, heavy pressure on the development of housing expenditure is to be expected. Increasing land and house prices as well as developing markets for mortgage loans will result in rising monthly expenditure for owners. At the same time the remaining rental housing stock, with mostly regulated rents, is under pressure to be liberalised.

The high owner occupation rates also have an impact on economic development in other ways. It is one of the major reasons for low mobility. Boeri and Brückner[3] described the low domestic mobility in CEE countries, which is clearly below the EU 15 average. A major reason for this is related to housing provision. Workforce ought to follow job opportunities. But in areas with low economic dynamic the market prices for condominiums usually are low. The asset of a (privatised) apartment subsequently can only partly be transferred to capital. In the booming regions on the other hand the

Graph 1: Housing tenancy in selected countries, 2002



Source: PRC (2005) , Ecorys (2005), IIBW

[3] Boeri, T., Brückner, H. (2000).

markets are hot. Any revenue of disposing the previous flat does not cover the cost for a new apartment. At the same time rental markets are divided with very low rents for people with old contracts and very high rents for others. In a situation, when revenues of selling a flat are disproportionate to the costs of a new one, it becomes unattractive to move from one city to another, regardless of the different income perspectives.

Not only migrants but also young households are mostly affected by the present situation. Privatisation in the nineties resulted in adequate housing provision for the tenants with residence at that time. Today new households, in particular young people in the stage of social establishment, are in a less advantageous position. The choices they have are to buy property, regardless of the high price to income-ratio, to accept a subletted apartment, to queue up for a social rented flat or to stay with their parents.

Hence, demand for housing construction is most urgent in metropolitan areas. South Eastern Europe as a whole has a high backlog regarding floor space per capita. The total demand of new construction within the next decade is estimated to be far beyond 2.5m units in the Central European EU Member States. For Poland alone demand is estimated at 1.6m apartments.[4] For South Eastern Europe a comparable estimation does not exist. Regarding approximate population and housing stock a similar demand of around 2.5m. apartments is assumable. This is a total demand of more than 5m units within one decade!

2.1 Why does not rental housing construction lift off?

Although construction of condominiums has recovered, rental housing construction is still below the required output to serve the needs of the population. This difference is due to the following reasons:

- The strong preference for property is not particularly stipulated in the national character of people. It is much more rooted in economic reasons. First of all property is regarded as a security against trouble of any kind, above all the future income situation. People experienced that property kept its value, when savings got lost and tenancy rights appeared to be insecure. Second, there is only little choice regarding investments. In countries with an underdeveloped banking sector people tend to convert their savings directly to bricks and mortar. Third, property is a way to pool the economic potential of several members of a family, including relatives who work abroad. Thus, investment in real estate promises a double dividend by having accommodation with low running costs and an increasing value of property.

- The sharp decline of public housing in the nineties was not reversed. Municipalities are only active in housing construction in a few countries (eg Poland). Generally the public sector tries to avoid being involved in housing construction again as it got rid of the obligations of a house owner by privatising big parts of the rental stock.

- Rental housing is not competitive today. As long as it is cheaper to finance property privately, renting an apartment is not attractive. For this reason there is no supply of rental flats and hence no market, which could develop.

- The profession of rental housing developers is not established in CEE and SEE countries. Currently, housing developers are often subsidiaries of construction companies. Their primary interest is to employ their own construction division and to get returns on investment as soon as possible. Long term investments are neither their core business nor their interest. Rental housing developers in contrast must have a long term perspective. There are well functioning models all over Europe. Particularly successful is the Austrian model of limited profit housing associations, which combines market economy principles with aspects of a non-profit regime. An important aspect of this model is that these companies are responsible both for development and long-term management of their buildings.[5]

- Mortgage systems do not provide adequate financing yet. Even though mortgage financing is developing rapidly, there is still a shortage in institutional financing. Development of financing instruments is closely related to institutional development in the housing sector ie the establishment of housing developers.

As a result of different economic development and EU integration, finance markets and financing instruments are developing differently in CEE and SEE countries. As shown in Graph 2, the outstanding balance of housing loans in these countries remains well below the level of advanced European countries and the US. Despite the small size, the lending market for housing in the region has been sharply growing, with average growth of roughly 65% per annum. In the EU-15 countries, the growth rate is about 7% (in 2003).[6] The recent upward trend in the mortgage loan market is according to analysts from Fitch Ratings[7] due to the following reasons:

- Falling real rates as a result of EU accession;

- Growing wealth in terms of net disposable income, between 1997 and

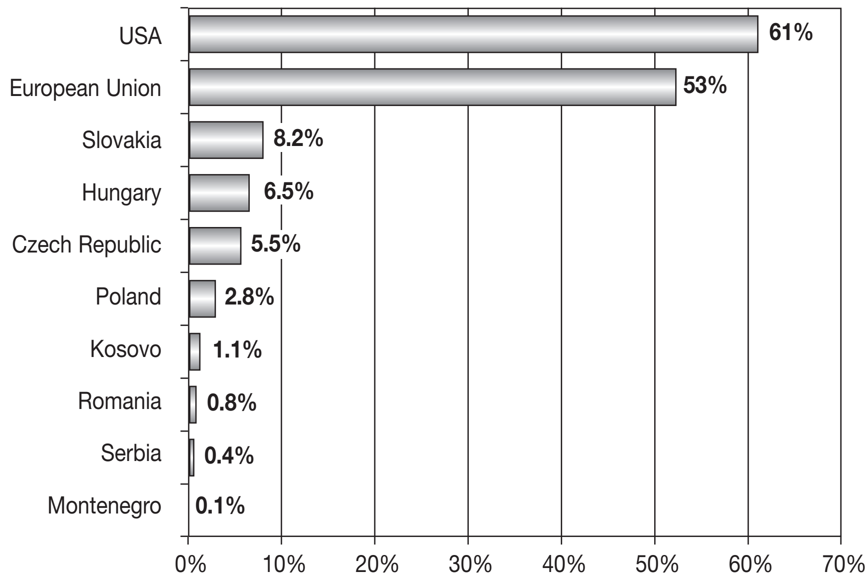
4 PRC (2004).

5 Amann/Mundt (2005).

6 OECD (2005).

7 Birney / Steinbarth (2005).

Graph 2: Mortgage loan to GDP-ratio in Central and Eastern Europe in comparison – as % of GDP, 2002



Data as per 2002, SEE 2004, Romania 1998

Source: Roy (2003), PRC/Ecorys (2005)

2002 wealth increased by 30% in Hungary and by 80% in some Baltic States;

- Banking sector restructuring;
- Legal and regulatory improvements and
- Housing promotion schemes.

In some CEE/SEE countries, margins are coming close to Western European levels. Mortgage loans are often refinanced by short term deposits, exposing banks to considerable interest rate risk. All countries in CEE and some in SEE have designed adequate mortgage bond legislation. Contract saving schemes exist in some CEE/SEE countries. They mainly target single family housing construction and renovation. Their volume differs substantially from country to country.

Foreign-currency mortgages became a very important part of housing finance, in particular in Poland and Hungary. Secondary market financing tools (eg MBS) have not yet gained importance in the region, despite intensive endeavours from the side of international institutions.[8]

Obstacles to further development of the mortgage loan market in SEE countries are the following:

- Low LTV ratios, which reflects that mortgages are mostly home equity loans. Mortgage loans are rarely used for home acquisition or for construction by developers;
- Additional collateral and guarantors are required on mortgage loans because of the poor legal infrastructure;
- Maturities are relatively short;
- Interest spread is still very high;
- Capital is concentrated in urban areas.

House prices are high and in some regions dramatically rising with price to income-ratios up to 17 (Montenegro, Serbia). Informal and illegal housing still is a major burden to the development of housing finance in many SEE countries. But efforts in legalisation on informal housing are achieved, in particular due to initiatives by the Stability Pact for South Eastern Europe.[9]

3 A Housing Finance Agency for CEE/SEE (HFA)

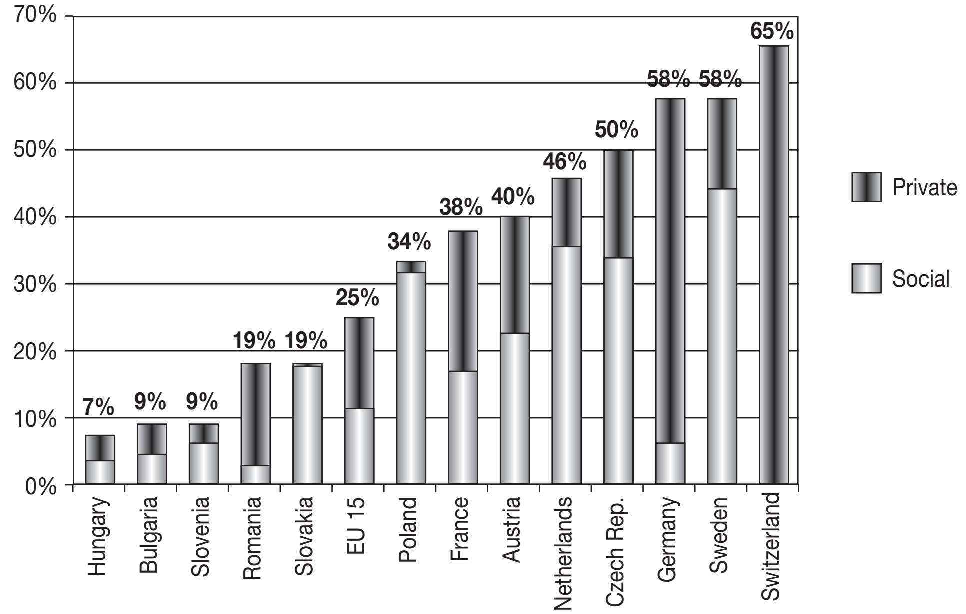
3.1 Necessity to lift rental housing construction

Compared to CEE and SEE countries, in most of Western European countries a much bigger part of the housing stock is for rent (as shown in graph 3). The endeavour to reduce rental housing has cooled off meanwhile.

[8] UNECE (2005), p. 17 f. Birney / Steinbarth (2005). Lliev / Yuksel (2003), p. 19. Hegedüs (2002), p. 41.

[9] Ministerial conference on informal settlements in South Eastern Europe (2004).

Graph 3: Rental housing stock in CEE/SEE and selected EU countries, 2002



Note: No data for a division in private/social rent for Switzerland available

Source: PRC Bouwcentrum (2005), Czischke (2005), CH Bundesamt für Statistik

Today the following functions are attributed to social and private rental housing in western European countries:

- Social rental housing is considered an instrument against poverty and social exclusion; it is of specific importance for young households, which cannot yet afford condominiums;
- Only a housing market with supply of all forms of housing may be efficient regarding consumer choice; under conditions of efficient institutional finance it may be economically rational for the consumer to rent instead of buying an apartment; under present market conditions in many urban areas in CEE and SEE affordability of condominiums is not yet achieved;
- There are several macroeconomic advantages of a well developed rental sector: It allows for labour mobility. As rents in social housing are usually limited, the sector is taken up as an instrument to influence total housing expenditure. In Austria, for example, the social housing sector is, due to its quantity and accessibility for the majority of consumers, able to influence even the price level of private rental market.[10]
- Rental housing offers institutional investment opportunities of rapidly growing importance. Due to risk spread rental housing is facing growing demand by real estate funds.

The high rate of rental housing in many Western European countries shows clearly its political significance.

3.2 Why a new instrument?

Despite growing awareness of the positive aspects of rental housing there seems to be no way of a trend reversal in CEE and SEE housing construction. Rental housing is seen either outright market oriented or fully subsidized. Private rental and social rental are regarded as two strictly distinguished products. However, Western European experience shows that these two products are only a small part of a big variety of combinations. Only capital market-financed apartments for rent for the top income groups are marketable all over Europe. Fully subsidized flats, in contrast, are too costly for the state to provide more than a small group of households in need.

Higher output in rental housing is achieved in some western European countries through different tools:

- Incentives for upscale rental housing: Tax reliefs for developers, buyers or tenants are widely-used. In Switzerland, which has the highest rental rate of Europe, a specific part of capital

[10] Amann / Mundt (2005).

investments is to be invested into rental housing. In this way funds with favourable terms are directed to (private) rental housing.

- Complex support for rental housing for lower and middle income groups: Any country which achieved a high level of social rental housing, made use of various instruments, which combine the strengths of the state (eg as guarantor) with market instruments. The most efficient and best documented models are the Danish Mortgage Bank institution[11] and the Dutch Social Housing Guarantee Funds (WSW Waarborgfonds Sociale Woningbouw). High efficiency is attributed to the Austrian model of social housing finance.[12] The state expenditure for housing promotion is, with 1% of GDP, lower than the OECD average. Quality of housing construction and housing provision are excellent. The housing expenditure rate is, with some 18%, comparably low. Last but not least a high level of equality in housing provision is achieved. Beside state subsidies capital market instruments have proven their effectiveness, in particular the instrument of housing banks, which acquire their capital by housing construction convertible bonds. All capital is bound to go to social housing. This limitation causes intensive competition between banks for housing associations with a good credit history.

The international community assists governments in countries in transition in introducing new models of housing finance. Some, as the contract saving scheme, are working already for a long time with success, taking its contribution to single family housing finance. Strong emphasis is presently placed on the Danish model of mortgage bonds. Similar models are tried to be introduced in several countries. Others, such as some models of annuity grants, were less successful.

In several CEE and SEE countries the conditions for financing upscale rental housing, on the one hand, and fully subsidized public housing on the other hand are given. But for the big in-between no clear perspective is visible yet. This gap may be partly closed with the model of the “Housing Finance Agency”, an institution which is aimed at working as an intermediary between national housing policy, international development banks, commercial banks and housing developers.

3.3 Social rental housing construction as a bankable product

Following the argumentation presented above, the introduction of a Housing Finance Agency as a new instrument in the housing finance markets in CEE/SEE countries is expected to achieve the following objectives:

Affordable rents

A new model only makes sense if the resulting rents for marketable flats are in a decent relation to incomes of typical households. The benchmark is a household of two earners in the civil service and a housing expenditure rate of less than 30%. Lower expenditure rates may be achieved with additional efforts by the public, eg by providing low-price land or additional customer-tied promotion (housing allowances). Resulting rents have to be considerably cheaper than privately financed condominiums. The model may be even more attractive, if a right to buy (eg after 10 years) is offered. This does not mean that rental housing for middle and lower income groups has generally to be subsidized by the public. But the public has to commit to a steering and leading role.

Achievement of a substantial increase in rental housing construction

In section 3.1, the necessity of an increase of rental housing is described as well as the limitations of existing instruments of public housing on the one hand and privately financed housing on the other end. To fill the growing gap between these two issues, a considerable construction volume has to be achieved. A new instrument for rental housing promotion has to contribute to a medium-range upswing in rental housing construction in CEE/SEE.

Conditions for introduction should be easy to fulfil

A new instrument of low profile and high efficiency should be easily implemented in any surrounding. It should be transparent and easy to audit, as it is considered an instrument to implement national housing policy targets.

Minimum subsidies

The prerequisite for low public expenditure is a considerable involvement of market players in rental housing projects, in particular commercial banks, developers and construction companies. Affordable rents can be achieved only through low construction costs and financing costs. Subsidies have a supportive role, as much as equity and a stringent time schedule of the construction process. A major role of subsidies will lie in the substitution of equity. The need for this will diminish in the long run.

With a system of incentives and sanctions, participating market players should be encouraged to achieve results with minimal costs. Incentives and sanctions have to be pinpointed towards the involved public bodies likewise.

Efficient construction costs should be obtainable, as the intended projects, due to their size, will be of major importance for the local construction industry. Additional measures shall be taken:

- Transparent tender and awarding of construction services;

[11] UNECE (2005), p. 28.

[12] Amann / Ramaseder / Riss (2005), Amann / Mundt (2005).

- Invitation of local and supra-regional companies to the tenders;
- Fixed price offers including defined delays;
- No changes of conception behind schedule;
- Quality control and their active promotion
- Transparent and quick procedure of payment;
- Preventing interventions of the construction process by the public.

To achieve minimum public expenditure it is essential to involve commercial banks to a large extent. Rental housing construction for middle and lower income groups has to become a bankable product.

Institutional reinforcement

The new model has to focus on the strengthening of institutional financing. The lack of an institutional framework for social housing is regarded as a major reason for insufficient rental housing provision. The setup of a third sector in housing should be promoted. This means an institution between market and state, following the principles of cost coverage, limited field of action, binding of property, limitation of profit. This type of housing developer is successfully operating in many European countries, eg in Scandinavia, the Netherlands and Austria. They ought to act in accordance with market economy principles, fulfilling policy targets of the state.

3.4 Expected Results

Within this framework the Housing Finance Agency will act as an intermediary linking the activities of the international development banks and commercial banks to the national housing policies of the target countries. The details of the organisation set-up and the applied instruments of HFA will be ready to discuss in public in the spring of 2006.

The introduction of an intermediary organisation like HFA will lead to a substantial improvement of rental housing conditions in CEE and SEE. The first steps of such an agency will be small ones. But in the course of establishing, this instrument may gain remarkable results:

- The importance of an increase in rental housing construction has been demonstrated. HFA will be an efficient tool to realize this.
- HFA represents a promising strategy to fill the gap between fully subsidized public housing and privately financed upscale rental housing.
- The model accelerates the development of institutional mortgage finance.
- The HFA will not collide with other initiatives in housing finance. HFA uses existing instruments and models by combining them in the most efficient way. In this context, western European housing finance models serve as guidelines.
- HFA may also become an efficient tool for implementing national housing policy.
- HFA will become an efficient facilitator for commercial banks to increase their financing volume with specific respect to institutional finance.
- HFA will become an efficient intermediary for international development banks to transform their products according to local needs.
- For all participants HFA will become a catalyst and a well-recognised third party for the realisation of housing development projects aimed at raising housing affordability for middle and lower income groups.

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South Africa's Financial Sector Charter: Where From, Where To?

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INTRODUCTION

Key to delivering an acceptable standard of housing to South Africa's low-income households – income less than R3,500/USD $580 per month – has been the need for affordable housing finance. For over fifteen years, in response to this need, various means to extend the delivery of housing finance have been pursued[1]. Housing finance institutions[2], one providing risk-mitigation, two acting as guarantors and two acting as wholesale funders, were established as a means of encouraging lenders into the low-income housing market. In addition, various lending instruments (eg mortgage loans, pension/provident-backed micro-loans, unsecured micro-loans and savings-linked-to-credit) have been offered by a variety of banks and non-bank 'alternative' lenders. Notwithstanding the above, the results in the case of the formal retail lender have never met expectations.

This paper briefly describes some of the problems and tensions that arose between the banks and the government during this period. It examines the response of government to its frustration with the low level of bank lending and how it embarked, in the past few years, on an attempt to compel banks to lend through the introduction of community reinvestment-type (CRA) legislation. It describes the response of the banks to such a move and their decision to embark on a Financial Sector Charter (FSC) process aimed at transforming the entire financial sector, including increasing investment and the extension of lending, into the low-income housing market. The paper describes how this new thinking aligns with government's recently restructured housing policy. Last, some of government's key themes in its new policy will be described as well as the financial proposals arising from the process.

The effect of this FSC process has been, for the time being, to sideline the CRA legislation government had in the pipeline as a means of compelling banks to lend to low-income households. Rather government and the financial sector have embraced a new approach where they have agreed to stop bickering as to whose fault the lack of lending is and to rather accept the realities of the low-income market and then work out realistic proposals to deal with its higher than normal risk profile. This paper will describe this process and attempt to draw some conclusions about this new partnership aimed at tackling the on-going problems around a lack of appropriate housing finance.

A BRIEF RE-CAP OF THE HOUSING POLICY

South Africa's housing policy was formulated, during 1992 and 1993, through a negotiated process that involved vigorous debates over, eg the standard of housing that should be provided ('four-roomed house' or 'progressive' – ie incremental housing) and how to attract financial institutions back into the embryonic black housing market that they had fled from during the late 1980s[3]. The financial institutions' flight was mainly due to a wildly fluctuating economy, which resulted in interest rate spikes that were simply unmanageable for first-time, newly mortgaged black homebuyers. In addition, the threat of politically inspired bond boycotts, which had become a weapon of the 'struggle' against apartheid, were making it difficult for banks to repossess houses where the mortgage loan had gone into default.

[1] This paper does not describe the trail followed in dogged pursuit of housing credit since the early 1990s, as this story has been fully documented in (Tomlinson, 1999; Tomlinson, 2002; Rust, 2002a; Rust 2002b).

[2] The key housing finance institutions set up to facilitate the delivery of housing finance are described at the end of the article.

[3] Black South Africans were legally barred from purchasing housing for ownership, using a mortgage bond, until the late 1980s. Within just over a year, these first-time home-buyers saw the interest rates charged on their bonds rise from 13% in 1987 to 20% in 1989, severely threatening their ability to repay the loans, forcing many of the households into default, and resulting in the first repayment boycotts (Tomlinson, 1997).

Key to the policy, launched in 1994, was the delivery of a once-off capital subsidy - the Housing Subsidy Scheme (HSS) (Department of Housing, 1994). It has been available to all households with an income of less that R3,500 (USD $580) per month. In 1994 the amount of the subsidy was R12,500, but has increased over time to R31,900 in 2005. While the subsidy is able to deliver a serviced site, and more recently a rudimentary structure[4], it is widely acknowledged that the amount of money available has been insufficient to provide a 'four-roomed' house, the vision promised by the ANC politicians at the time of the 1994 elections. Nevertheless, since 1994 government has spent R29.5 billion to provide 1.6 million housing opportunities (Department of Housing, 1994) to low-income households.

By linking subsidies to mortgage loans, the expectation was that households would be able to afford a conventional house. However, due to affordability constraints very few subsidy beneficiaries (less than 10%) have accessed mortgage finance (Public Service Commission, 2003). A commitment to providing credit was therefore needed from the financial sector to provide the end-user finance, which could make the vision a reality.

GOVERNMENT'S RESPONSE: COMMUNITY REINVESTMENT-TYPE LEGISLATION

Going back to the early 1990s, there was often a demand from the 'left' in South African politics to introduce CRA-type legislation in South Africa. In more recent years this view was taken up by government arguing that the South African banking sector was not taking sufficient positive action to address the housing finance needs of the low-income, previously disadvantaged population. Moreover, the banks were viewed as practicing 'red-lining' as a way of discriminating against low-income households, consistently denying them mortgage bonds in particular geographic areas, eg the former black townships and the inner-cities where black people moved following the lifting of the Group Areas Act (GAA) in 1991 – the GAA forced race groups to reside within their own areas.

Modeling itself, to some degree, on the United States the South African government began systematically rolling out a package of legislation, beginning with the Promotion of Equality and Prevention of Unfair Discrimination Act, 2000 (similar to the US Fair Housing Act) followed by the Home Loan Mortgage Disclosure Act, 2000 (similar to the US Home Mortgage Disclosure Act) and in 2002 a Community Reinvestment (Housing) Bill.

In a nutshell, the Equality Act makes it an offence to discriminate on the grounds of race or gender. The Disclosure Act, which by 2005, had still not come into operation, sets out what financial institutions must disclose in terms of their home loan business with the intention of identifying problem areas where lending is not occurring. More specifically, the lending figures expected to result from the Disclosure Act were supposed to reveal which retail banks were and were not lending, how much they were lending and where, and to whom they were lending. This second piece of legislation grew out of government's frustration in trying to 'guess' how much lending the retail banks were actually doing in the low-income market.

The CRA Bill, which followed in 2002, focused on extending housing finance to un- and under-served communities as revealed through the Disclosure Act. The CRA Bill was drafted to compel financial institutions, in the business of providing home loans, to set aside a portion (to be prescribed) of their home loan funding for lower- and middle-income households. Similar to the United States legislation, the Bill specifically states that in making such finance available, financial institutions are not expected to resort to 'unsound' lending practices.

The key provision in the Bill states that if a financial institution is unable to meet its targets by *direct lending* to the target population then it may opt for one of the following:

- providing funding through a prescribed wholesale lender at a mutually agreed interest rate for on-lending to niche lenders to provide end-user loans;
- purchasing wholesale lenders' securities and debt issues; and
- providing funding directly to niche market lenders (defined as a financial institution for which more than half of its outstanding Rand volume of home loans are to households with low- or medium-income levels) to make available for end user loans.

In reviewing the Bill one could argue that in drafting it with the above provisions government was to some degree acknowledging that the formal retail banks might not be able to do profitable business in the low-income market, and therefore gave them a variety of options to meet their targets. In other words, if there were other lenders, eg alternative non-bank ('niche") housing lenders that were able to profitably lend in this market then individual banks could partner with them to fulfill their targets.

Other critical points of the Bill include:

- a 'financial institution' is defined (in addition to the traditional retail banks) as any other registered institution whose business is, in full or in part, either the acceptance of deposits from the general public or the advance of credit with the security of a registered mortgage bond or any other accepted security (eg pension/provident fund benefits); and

[4] With the adoption of the National Housing Code (2000), basic minimum standards have been set down which require a rudimentary structure of 30 square metres be provided on a serviced site.

- a financial institution must abide by the principles of courtesy, transparency and openness in dealing with potential borrowers[5].

In evaluating the proposed legislation, it has been argued that the United States approach to the CRA was based on needs and circumstances peculiar to that country (Diamond, 2002). In the United States in the 1960s and 1970s, concern grew over the socio-economic decline of central city residential areas, often as a result of red-lining through which lenders would determine certain geographic areas to be un-mortgageable because of perceived high credit risk due to declining property values. The US legislation was therefore directed more at geographic areas than at low-income households.

Subsequent examinations (Diamond, 2002) of the United States' CRA legislation have revealed it to be only 'mildly stimulating' in terms of depository institutions making loans to distressed areas. The legislation provided for the use of regulatory factors, such as being able to withhold permission for banks to consolidate unless they met the credit needs of the entire geographic area they were located in, ie chartered in, to nudge the banks to extend their lending.

More specifically, performance was to be assessed through regular examinations, however, sanctions would only come into effect when an institution requested, eg a change of licence, wanted to relocate a branch and so on. The legislation did not, therefore, 'compel' banks to lend but rather 'encouraged' them to do the right thing, with the result of this approach, over a twenty-year period, being fairly minimal.

Subsequently Temkin (in Diamond, 2002) has noted that it was the Financial Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) enacted in 1992, which placed a requirement on the two Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac to broaden their reach to actual low-income households, that eventually made a significant difference to the lower-end of the U.S. housing market.

HOW APPROPRIATE IS CRA TO SOUTH AFRICA?

At the time the South African Community Reinvestment Bill was drafted, it was acknowledged that the situation in South Africa was very different. For one thing, in the United States banks are limited as to where they can operate through the requirements of federal and state charters. In South Africa, the Big Four retail banks (Standard Chartered, Nedbank, RMB and ABSA) operate throughout the entire country and are not dependent on government permission for where they carry out their business or how they structure it.

Second, because of the reversed demographics whereby in the United States the lower-end of the market is the minority, but in South Africa, the lower-end of the market makes up the majority, the potential for systemic risk to the United States' banking sector is much lower if its banks wind up doing a degree of 'unsound' lending. In South Africa the risk to the banks from 'unsound' lending is much higher because the numbers are so much larger.

Moreover, 'red-lining' a geographic area in South Africa has often arisen because of repayment problems. These repayment problems began as tool of the 'struggle' in the early 1990s and then drifted over into being the result of economic hardship, which was resulting from the loss of 500,000 formal jobs over the past decade. Obviously, in comparing the situation in the two countries, the type of abnormal repayment situation, which has grown up, and to some degree become endemic, in South Africa, is not something the United States has had any experience in dealing with.

The issue then was whether to take a more aggressive approach, which could take the form of introducing geographically-based lending targets, which could result in 'unsound' lending, as a response to the bank's 'red-lining' or simply to promote the 'extension of lending' to the population being targeted. In the end the Bill veered from the United States' approach in two ways. First it 'compels' the banks, rather than nudges them, to carry out lending. It focuses, however, on targeting 'income levels' rather than 'geographic areas', a clear distinction when applied to the local situation.

THE FINANCIAL INSTITUTIONS RESPOND

As expected the South African financial sector rapidly rose to meet the challenge by warning the markets that the government was going to compel them to carry out 'unsound' lending, which would have the effect of unnerving overseas investor confidence, resulting in a lowering of the banks' share prices.

In determining its response, the financial sector, it appears, was sufficiently worried about the proposed legislation to move proactively to sideline the Bill by proposing its own Financial Sector Charter.

Financial Sector Charter (FSC)

In October 2003, the financial sector[6] announced its commitment to a transformational Financial Sector Charter (FSC) (Banking Council, 2003) for the industry that would provide for increased access to financial services for poor households and communities, and direct billions of Rands of investment into transformational infrastructure, agricultural development, low-income housing (R42 billion) and SME businesses (R5 billion).

By 2003 a Low-income Housing Task Group had been established by the financial sector

[5] This point arose from the fact that low-income people have often felt there were being treated discourteously by employees of the retail banks.

[6] A financial institution means a bank, a long-term insurer, short-term insurer, re-insurers, managers of formal collective investment schemes in securities, investment managers and other entities that manage funds on behalf of the public, including retirement funds and members of any exchange licensed to trade equities or financial instruments in this country and entities listed as part of the financial index of a licensed exchange.

to determine the broad outputs that were desired from the process. It was determined that all parties committed to the Charter would work in partnership with government and its Development Finance Institutions, eg the National Housing Finance Corporation, to commit themselves to mobilizing resources.

Through the Charter process, Government wanted to see, eg:

- sustained transformation in the manner and scope of engagement by the financial sector in historically under-serviced markets;
- greater penetration of private sector housing finance;
- increasing private financial support for a greater range of tenure and housing options; and
- the elimination, where it might exist, of unfair discrimination.

During this past year a package of measures key to unlocking finance through appropriate risk-sharing arrangements were proposed by the financial sector to government. The banks, being well aware of their obligation to both shareholders and depositors are keen to push for a cautious and balanced approach to low-income housing funding in extending their commercial risk beyond the conventional mortgage market where they currently operate. In formulating proposals, there is a recognized need for government support. Some of the support they have been negotiating with government has included:

- development of a securitisation (conduit) model[7], with government participation in its funding, as a means funding lending via a secondary market mechanism;
- Loss Limit Insurance, which would cover some of the abnormal 'political' risk still associated with this market and underpin the securitisation model;
- development of a Fixed Interest Rate loan[8] product to address the volatility in rates, which has been key to pushing low-income households into default.

Other issues being examined in relation to the establishment of a 'conduit' are where to house it, either in the private or public sector, and whether an institution already in operation should be used, or an entirely new institution should be created.

In addition, there is a commitment to normalize under-performing markets. This proposal takes the form of government and the financial sector developing a common approach to tackling selected pilot areas where repayment problems have continued to this day. Initiatives to break these logjams would focus on working with the local authority, community groups and so on to tackle the problems

Some tensions have arisen in the Charter process in that, on the one hand, it is framed around a strong delivery oriented work programme to be driven by targets and timeframes. On the other hand it is aimed, over a much longer period, at transforming the entire sector. Moreover, in implementing the Charter's goals, strategies for doing so cut across a number of areas of responsibility for formulating and implementing proposals, including banks operating individually and collectively and the financial sector acting with and without government. For example, the targets that have been set are divided into those the banks believe they will be able to meet without government support and those requiring government support (as described above). More specifically, the banks are of the view that there is a certain level of additional credit they will be able to extend even if the government, in the end, does not agree to the supports being proposed. Only time will tell whether they find themselves having to move forward on their own, or with government support.

GOVERNMENT'S NEW HOUSING STRATEGY

The timing of this initiative comes just as government has recently released its own new housing strategy, Breaking New Ground …(Department of Housing, 2004). In the first ten years of the housing policy, government focused on addressing the country's housing backlog as rapidly as possible, resulting in a single-minded focus on 'quantity', while critics note, ignoring 'quality' (Kahn & Thring (eds) 2003). The new vision shifts away from the 'quantity' to the 'quality' of housing delivery, and particularly the delivery of sustainable human settlements, which will be better located, accessible to economic activities, provided with social and cultural amenities and so on. Most noteworthy is government's decision to extend its role to that of supporting the entire residential property market, not just the low-income market, as a means of 'breaking the barrier between the first economy residential property boom and the second economy slump' (Department of Housing, 2004: 7).

In its new housing strategy, government commits itself to expanding its scope and mandate to include households earning up to R7,500 per month by investigating the provision of a mechanism to overcome this portion of the market's down-payment barrier. This move in itself, if implemented, would ensure a greater number of borrowers for the banks to serve. Besides the financial mechanisms that are on the table, the Department of Housing also intends finally establishing an Office of Disclosure, as called for under the Home Loan and Mortgage Disclosure Act, as a means of monitoring the banks' performance, critical to determining whether the banks are delivering on their promises around low-income housing finance.

Where for the past ten years these two adversaries, the banks and government, have been locked into their own perceptions

[7] The proposal is for the development of a conduit for selling paper into the capital markets as a means of increasing lenders' funding capacity.

[8] The local banks do not believe there is sufficient market opportunity in South Africa for the private-sector to hedge the interest rate risk and are looking at international examples of where government has stepped in to take on a portion of lenders' risk.

as to whose fault the lack of lending belongs, it is now apparent that there is a tacit agreement to discard this chicken-and-egg mentality in favour of accepting the realities of the low-income market and then working out realistic joint proposals to deal with them. The willingness of government to both acknowledge and accept some of the risk of doing business in this market should be viewed as a clear change in its mindset. Expectations have been raised and promises have been made. The results will be for all to see.

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SOUTH AFRICAN HOUSING ORGANISATIONS

National Housing Finance Corporation – established in 1996 as a wholly-owned South African government state-mandated Development Finance Institution (DFI), operating as a public company. It mission is to formulate initiatives that will mobilize housing finance for low-to-moderate income households, by providing wholesale finance and underwriting funding for retail financial intermediaries and social housing institutions – see www.nhfc.co.za.

National Urban Reconstruction and Housing Agency – set up by government in 1995, as a Section 21 (not-for-profit) company to provide bridging loans to developers and contractors managing the construction of low-income housing projects – see www.nurcha.co.za.

Rural Housing Loan Fund – established in 1996 as a Section 21 (not-for-profit) company with a grant of DM 50 million of soft capital from the German Development Bank (KfW), its mandate is to assist very poor people living in the rural areas to improve their housing conditions. It does this by providing wholesale finance to retail intermediaries operating in the rural areas - see www.rhlf.co.za.

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Turkey: Rapid Progress Towards a Secondary Mortgage Market

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I. The Changing Face of the Turkish Housing Finance Industry

Since the publication of our article in the March 2005 issue of HFI, Turkey has progressed considerably in its endeavors to establish a functioning housing finance system. Yet Turkey's chronic housing-related problems of lack of building and occupancy permits, deficiencies in appropriate urban planning, and overall affordability, persist. A clear illustration of these is the fact that more than half of the housing stock in Turkey consists of dwellings without occupancy and/or building permits which causes the monetary value represented by a huge stock of real estate not fit to be introduced to the capital markets, leading to poorly recorded transactions.

The urbanization that gained momentum in the 1950s led to an increase in the population in big cities, hampering a balanced urban distribution. Over the last five decades, the proportion of urban population to total more than doubled, as depicted in Table 1 below. This led to significant socioeconomic problems, and rapidly increased the investment requirements in urban infrastructure. At the end of 2000 for example, 23% of the total population was settled in Istanbul, and 44 % of the total urban population was settled in cities whose population is over one million. Adequate urban housing supply could never keep up with the demand. Matters are made worse because 90% of Turkey's land is under serious earthquake risk, and an estimated 40% of the urban housing stock needing serious structural strengthening.

Affordability, on the other hand, seems to be the most striking issue regarding home ownership. According to 2000 census data, 68.2% of the total households own their houses, 23.9% of them are leaseholders, 2.1% of them live in government housing while 4.9% of them are neither leaseholder nor own their houses[1]. Although the homeownership rate seems to be satisfying, this figure includes illegal squatter housing, summer homes, second homes, and

Table 1: Urban Population Growth

Years	Urban Population	Urban Population (% of total)
1955	6,927,343	28.79
1960	8,859,731	33.69
1965	10,805,817	34.42
1970	13,691,101	38.45
1975	16,869,068	41.81
1980	19,645,007	43.91
1985	26,865,757	53.03
1990	33,326,351	59.01
1997	40,882,357	65.00
2000	44,006,274	64.90

Source: State Institute of Statistics

[1] State Institute of Statistics

Table 2: GDP figures of Turkey between 1976 and 2006 (estimated)

	Billion $ (3)	Growth Rate	Mid-Year Population (1)		Per Capita GNP $ (3)	Per Capita GDP In Purchasing Power Parity (2) ($)
			x1000	% Change		
1976	54.7	9.0	40,915		1,312	1,795
1977	62.2	3.0	41,769	2.1	1,488	1,945
1978	68.4	1.2	42,641	2.1	1,604	2,081
1979	76.6	-0.5	43,531	2.1	1,760	2,198
1980	69.7	-2.8	44,439	2.1	1,570	2,288
1981	72.8	4.8	45,540	2.5	1,598	2,564
1982	65.9	3.1	46,688	2.5	1,412	2,750
1983	62.2	4.2	47,864	2.5	1,299	2,934
1984	60.8	7.1	49,070	2.5	1,238	3,168
1985	68.2	4.3	50,307	2.5	1,356	3,320
1986	76.5	6.8	51,433	2.2	1,487	3,552
1987	87.7	9.8	52,561	2.2	1,668	3,911
1988	91.0	1.5	53,715	2.2	1,693	4,042
1989	108.7	1.6	54,894	2.2	1,979	4,116
1990	152.4	9.4	56,154	2.3	2,712	4,566
1991	152.4	0.3	57,272	2.0	2,656	4,676
1992	160.7	6.4	58,392	2.0	2,752	4,973
1993	182.0	8.1	59,513	1.9	3,055	5,393
1994	131.1	-6.1	60,637	1.9	2,159	5,110
1995	172.0	8.0	61,763	1.9	2,783	5,487
1996	184.7	7.1	62,909	1.9	2,933	5,918
1997	194.4	8.3	64,064	1.8	3,030	6,298
1998	206.0	3.9	65,215	1.8	3,156	6,451
1999	187.7	-6.1	66,350	1.7	2,825	6,084
2000	201.5	6.3	67,420	1.6	2,987	6,820
2001	144.6	-9.5	68,365	1.4	2,111	6,155
2002	182.9	7.9	69,302	1.4	2,638	6,550
2003	238.4	5.9	70,231	1.3	3,396	6,993
2004	301.6	9.9	71,152	1.3	4,240	7,756
2005 (4)	357.7	5.0	72,065	1.3	4,964	8,428
2006 (5)	380.6	5.0	72,974	1.3	5,216	9,017

Source: SIS, SPO, OECD

(1) SIS mid-year population estimate

(2) Necessary data for the computations of Purchasing Power Parity are compiled by SIS and sent to OECD, and later by using the parity value computed by OECD Per Capita GDP is computed by SIS.

(3) Computations are made by using Central Bank FX rate.

(4) SPO estimate

(5) Projection

dwellings without a permit that constitutes more than 50% of home owners. Further amplifying the problem is Turkey's young population necessitating an immense increase in new household creation. The number of marriages has been breaking records over the last three years. Therefore, there remains a significant proportion of the population still underserved. Concerning access to the institutional means of housing finance, the picture is far from adequate: only 3% of the population is being served. The ratio of outstanding housing loans to GDP is around 1.5% in Turkey, whereas the range is 4 - 12% in Latin American countries, 1 - 22% in Middle Eastern countries, 2 - 59% in Southeast Asian countries, 71% in USA, 46% (average) in the EU[2].

II. Latest Developments in the Primary Market

Housing loans have been extended by commercial banks in Turkey since the 1950s. The initial players in the industry were state banks chartered to provide housing finance to urban populations. Private commercial banks started to extend housing loans in the 70s. The long-time leading player of the industry, state-owned Emlak Bank (literally Real Estate Bank) ceased operations in 2001. Its void is yet to be filled. The remaining state-owned banks are not vying to lead initiatives in the industry. Nevertheless, private players in Turkey's vibrant banking industry have gained significant headway in consumer products over the recent years.

As of today, most of the commercial banks extend (Turkish currency) YTL-based housing loans with maturities varying from 12 to 300 months. Products with over 120 months of maturity have been introduced only over the last 10 months, as the economy has improved. USD-based products, which for a long time dominated the longer-term segment, had been losing the favor of the consumers. Monthly interest rates on these products are presented in Tables 3a and 3b.

In October 2005, the average annual consumer price index increase stood at 7.54%, almost equaling the annual target of 8%.

Table 3a*: Monthly Interest rate for housing loans in YTL for maturities from 12 to 360 months

	12	24	60	120	144	180	240	360
Akbank	1.18	1.18	1.18	1.18	1.18	1.18	1.18	-
Bank Europa	1.05	1.05	1.05	1.05	1.05	1.05	1.05	1.05
Garanti	1.20	1.20	1.20	1.20	1.20	1.20	1.20	-
HSBC	1.14	1.14	1.14	1.14	1.14	1.14	1.14	1.14
Isbank	1.20	1.20	1.20	1.20	1.20	1.20	1.20	-
Oyak Bank	1.20	1.20	1.20	1.20	1.20	-	-	-
Yapi Kredi/Koçbank	1.20	1.20	1.20	1.20	1.20	1.20	1.20	-
Ziraat Bank	1.19	1.19	1.19	1.19	-	-	-	-

*Ranked in alphabetical order

Source: Bank statements, (November 2005)

Table 3b*: Monthly Interest rate for housing loans in USD for maturities from 12 to 240 months

	12	24	60	120	180	240
Akbank	0.70	0.70	0.75	0.75	-	-
Bank Europa	0.61	0.61	0.64	0.66	0.69	-
Garanti	0.70	0.70	0.75	0.75	0.75	0.75
HSBC	0.64	0.64	0.64	0.64	0.64	0.64
Isbank	0.70	0.70	0.75	0.75	0.75	0.75
Oyak Bank	0.69	0.69	0.69	0.75	-	-
Yapi Kredi/Koçbank	0.69	0.69	0.69	0.75	0.75	0.75
Ziraat Bank	-	-	-	-	-	-

*Ranked in alphabetical order

Source: Bank statements, (November 2005)

[2] Capital Markets Board of Turkey

Table 4: Consumer Price Index. Annual Percentage Change Between 01/1994 and 10/2005

	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec
1994	69.65	72.96	73.65	107.45	117.81	115.84	109.35	108.05	111.13	116.27	119.73	125.49
1995	125.89	122.42	119.67	88.41	79.81	80.73	80.63	83.25	85.84	84.21	81.53	76.05
1996	78.11	77.49	79.34	80.83	82.93	82.86	81.20	81.93	79.32	79.59	80.38	79.76
1997	75.72	77.65	77.30	77.16	77.46	78.05	85.23	87.79	89.86	93.16	95.82	99.09
1998	101.62	99.25	97.18	93.57	91.37	90.55	85.35	81.43	80.43	76.64	72.77	69.73
1999	65.90	63.93	63.54	63.85	62.97	64.27	65.00	65.40	64.27	64.70	64.55	68.79
2000	68.88	69.75	67.90	63.82	62.67	58.62	56.21	53.17	48.96	44.44	43.76	39.03
2001	35.92	33.42	37.51	48.27	52.39	56.10	56.33	57.50	61.80	66.47	67.29	68.53
2002	73.16	73.08	65.11	52.72	46.22	42.60	41.28	40.24	37.05	33.45	31.77	29.75
2003	26.38	27.01	29.41	29.45	30.74	29.76	27.44	24.91	23.00	20.78	19.25	18.36
2004	16.22	14.28	11.83	10.18	8.88	8.93	9.57	10.04	9.00	9.86	9.79	9.32
2005	9.23	8.69	7.94	8.18	8.70	8.95	7.82	7.91	7.99	7.52		

Source: SIS

The price increases in the housing sector was 10.11% in the same period, denoting the increased activity in housing sales. Industry experts[3] attribute a significant portion of this increase to decreasing interest rates and more readily available housing loans. Oyak Konut market studies show a marked rise of around 40% in house prices in selective high growth residential areas of Istanbul and Ankara compared to the 3rd quarter of 2004.

Falling interest rates after 2003 have increased the demand for housing and created an increase in house prices above average consumer price rates. The house price spikes after the 2001 crisis were, on the contrary, below the consumer price rates due to the stagnancy in the economy and inconsistency in the market. There are some doubts as to whether a house price bubble currently exists, however. It should be noted that house prices have merely reached the pre-crisis levels in real terms. It

Table 5 : Monthly percentage changes in consumer and housing prices between 01/2001 and 10/2005

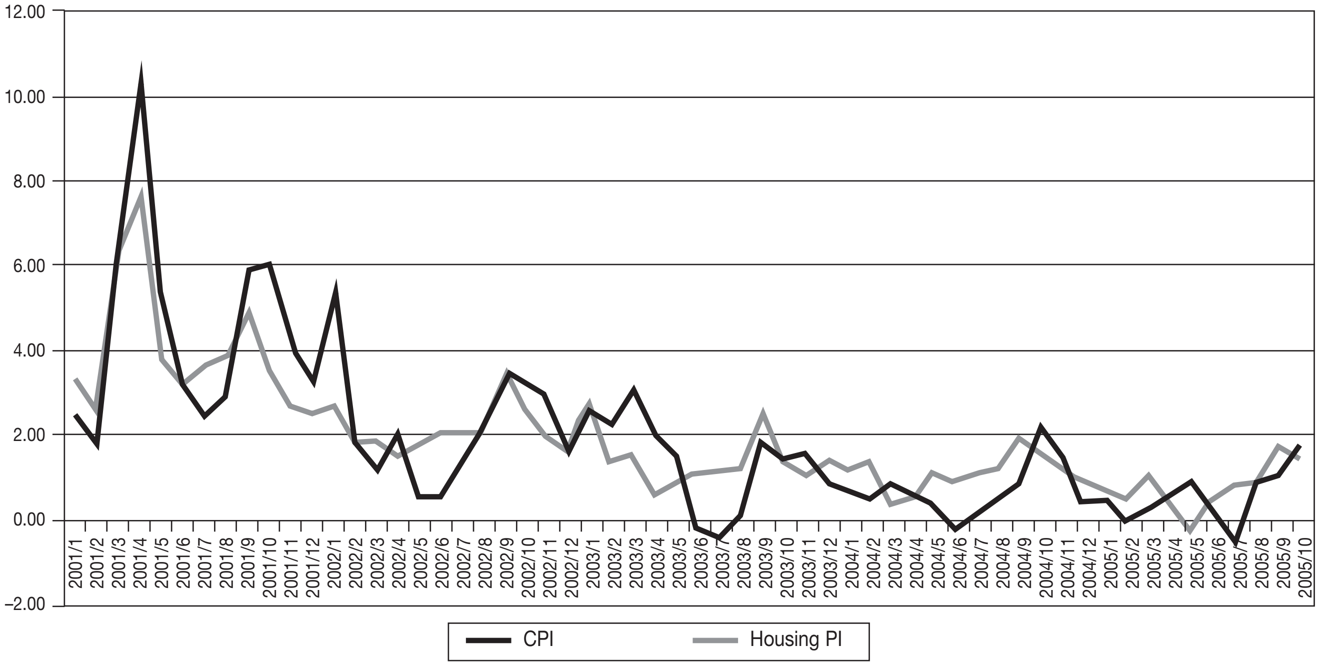
2001	CPI	Housing	2002	CPI	Housing	2003	CPI	Housing	2004	CPI	Housing	2005	CPI	Housing
1	2.49	3.36	1	5.32	2.71	1	2.58	2.84	1	0.74	1.17	1	0.55	0.67
2	1.80	2.58	2	1.77	1.86	2	2.26	1.37	2	0.55	1.43	2	0.02	0.51
3	6.09	6.16	3	1.18	1.91	3	3.10	1.59	3	0.88	0.38	3	0.26	1.08
4	10.31	7.68	4	2.05	1.50	4	2.09	0.60	4	0.59	0.48	4	0.71	0.38
5	5.06	3.77	5	0.58	1.68	5	1.58	0.89	5	0.39	1.15	5	0.92	-0.30
6	3.13	3.13	6	0.59	2.09	6	0.17	1.12	6	0.13	0.89	6	0.10	0.57
7	2.41	3.65	7	1.44	2.11	7	0.38	1.16	7	0.22	1.15	7	0.57	0.87
8	2.94	3.90	8	2.17	2.15	8	0.16	1.20	8	0.58	1.24	8	0.85	0.91
9	5.88	4.97	9	3.49	3.47	9	1.91	2.57	9	0.90	2.00	9	1.02	1.80
10	6.07	3.48	10	3.28	2.65	10	1.42	1.39	10	2.20	1.60	10	1.79	1.47
11	4.22	2.71	11	2.91	1.97	11	1.61	1.08	11	1.50	1.20			
12	3.23	2.45	12	1.65	1.59	12	0.88	1.42	12	0.45	0.90			

Source: SIS

(1) After the year 2004, 2003=100 basis index is used.

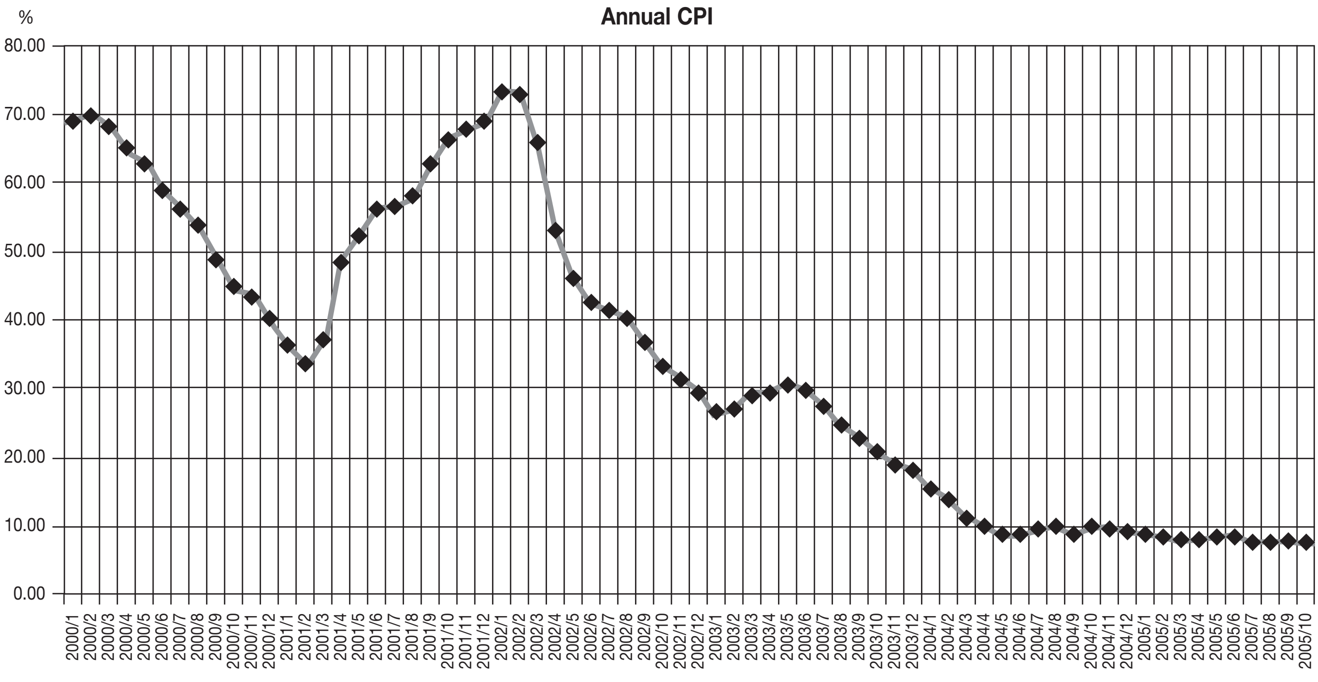
[3] OYAK Analyses

Graph 1: *Monthly* percentage changes in consumer and housing prices between 01/2001 and 10/2005



Source: Undersecretariat of Treasury

Graph 2: *Annual* CPI from 01/2000 to 10/2005



Source: Undersecretariat of Treasury

is economically logical to expect house prices to continue to increase until interest rates reach a reasonable level. Government entities should educate consumers effectively in order to prevent an excessive demand which would eventually lead to a market bubble. Monthly housing prices as compared to the consumer price index since 2001 are shown in the Table 5 and Graphs 1 and 2.

With sovereign borrowing rates down from around 90% in the early 2000s to around 15% today, a primary income source for banks and financial institutions in Turkey is depleted. The banks in turn had to resort to increasing their exposure to corporate and consumer debt at unparalleled levels. As a result of that, the consumer loan portfolio of the Turkish banking industry grew by 152% per annum. 2003 was a key year as due to the improving macroeconomic outlook, further progress towards EU membership accession, and a 3-year stagnancy in housing prices, demand for housing loans rose. This demand also led to a significant increase in house prices as mentioned above. This trend continued in 2005.

Consumer Loans

According to data collected from the Banks Association of Turkey, 2,790,663 persons used consumer loans of TRL 10,159 million during the second quarter of 2005. The total balance of customer loans outstanding amounted to TRL 19,538 million and the number of borrowers outstanding was 5,220,284 at the end of the second quarter.

Delinquency rates of Turkish consumer loans have historically been comparatively quite low, around 2-3%. The non-performing portion of housing loans experienced by the dominant players in the industry were less than 1% even during 2001-2002, when Turkey experienced the worst economic crisis in its history

Outstanding consumer loans which are under legal follow-up amount to TRL 150.5 trillion, which accounts for 0.3% of total consumer loans. The breakdown of the total legal follow-up cases of automotive loans, real estate loans, general purpose loans and others in consumer loans under legal follow up are 45 percent, 14 percent, 39 percent and 3 percent, respectively.

In our March 2005 article, we detailed some of the structural impediments facing the development of an appropriately functioning housing finance system in Turkey, such as

Table 6: Consumer loans extended and outstanding consumer loans quarterly between Q1 2004 and Q2 2005.

TRY* Thousand Period	Type of Currency	Consumer Loans Extended				Outstanding Consumer Loans			
		Volume	No. of Users	Admin. Follow-up	Legal Follow-up	Volume	No. of Users	Admin. Follow-up	Legal Follow-up
2004 March	**TRY**	4,908,566	852,592	11	8,221	10,498,870	2,839,519	8,675	54,262
	FX	200,983	2,786	0	1,141	614,250	13,873	1,494	1,318
	Total	**5,109,549**	**855,378**	**11**	**9,362**	**11,113,120**	**2,853,392**	**10,169**	**55,580**
2004 June	**TRY**	6,383,728	913,428	145	10,528	13,939,985	3,146,779	10,650	60,534
	FX	227,508	2,821	0	697	686,189	13,684	1,379	1,386
	Total	**6,611,236**	**916,249**	**145**	**11,225**	**14,626,174**	**3,160,463**	**12,029**	**61,920**
2004 Sept.	**TRY**	4,142,952	679,480	0	16,142	15,086,062	3,350,606	16,627	74,426
	FX	212,878	2,679	0	797	733,628	14,345	1,598	1,393
	Total	**4,355,830**	**682,159**	**0**	**16,939**	**15,819,690**	**3,364,951**	**18,225**	**75,819**
2004 Dec.	**TRY**	4,906,381	938,657	0	20,917	15,924,234	3,518,789	14,220	104,042
	FX	360,696	3,702	0	1,145	869,803	15,372	2,015	2,367
	Total	**5,267,077**	**942,359**	**0**	**22,062**	**16,794,037**	**3,534,161**	**16,235**	**106,409**
2005 March	**TRY**	6,861,331	2,154,335	2,422	32,126	17,934,157	4,745,062	13,414	129,872
	FX	304,845	2,965	0	1,320	929,080	15,486	2,128	1,340
	Total	**7,166,176**	**2,157,300**	**2,422**	**33,446**	**18,863,237**	**4,760,548**	**15,542**	**131,212**
2005 June	**TRY**	10,159,357	2,790,646	9,864	27,017	19,537,164	5,220,231	25,652	150,540
	FX	374	17	0	0	665	53	0	15
	Total	**10,159,731**	**2,790,663**	**9,864**	**27,017**	**19,537,829**	**5,220,284**	**25,652**	**150,555**

(* as of 1.1.2005 1 TRY=1,000,000 TRL)

Source: BAT

Table 6: Breakdown of Consumer Loans According To Purpose

	April-June 2005		
	TRL million	**Number of Persons**	**Percentage Share**
Flow terms			
Automobile	1,676	92,408	16
Real estate	3,071	72,398	30
General Purpose Loans	5,399	2,625,483	53
Other	13	374	0.1
Stock terms			
Automobile	5,009	451,895	26
Real estate	6,073	209,104	31
General Purpose	8,279	4,292,100	42
Other	176	267,185	0.9

lack of a standardized appraisal system, lack of diversified primary market products, lack of long term funding sources, etc... There is a growing market expectation with regards to the removal of these impediments. The end consumer and lender expectations focus primarily on primary market practices, whereas eager investors are seeking remedies for structural deficiencies of the capital markets and relevant instruments.

In the primary market front, title and registration regulations, foreclosure and bankruptcy law and its applications, as well as Consumer Protection Law have been the center of attention. The above mentioned laws and regulations are in general extensive and have been brought in conformance with the European Union standards over the past decade. However some microscopic provisions in these regulations have been disturbingly inefficient.

The bankruptcy and foreclosure practices certainly play a crucial role in determining the value of the collateral. Although the Turkish bankruptcy and foreclosure law is very much in conformance with European Union standards, the liquidation process can last up to three years. This is a major constraint for investors who intend to invest in Turkish mortgage assets.

Yet another set of impediments is the significant costs associated with a typical housing transaction. Stamp duties, resource utilization fund, banking and insurance transactions tax, title fee, and notary expenses are some of these costs. These costs certainly do not help the banks in creating affordable housing loan products.

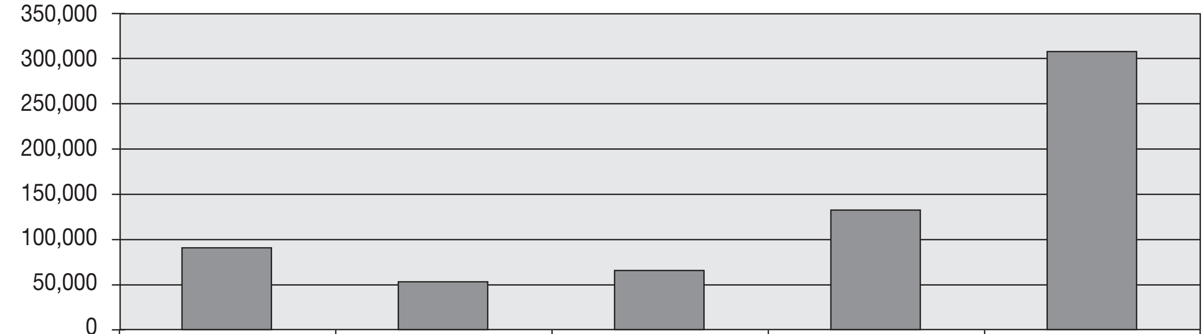
Table 7: Breakdown of home loans as a subset of consumer loans per quarter between Q2 2004 and Q2 2005

Home Loans		2005 June		2005 March		2004 Dec		2004 Sept		2004 June	
		TRY 1000	**Number of borrowers**	**TRY 1000**	**Number of borrowers**	**TRY 1000**	**Number of borrowers**	**TRY 1000**	**Number of borrowers**	**TRY 1000**	**Number of borrowers**
Amount	**TRY**	3,070,679	72,398	1,158,795	28,691	464,920	33,825	420,919	15,547	786,745	28,399
Extended	**FX**	-	-	172,212	979	191,701	1,415	107,706	847	104,192	774
	Total	**3,070,679**	**72,398**	**1,331,007**	**29,670**	**656,621**	**35,240**	**528,625**	**16,394**	**890,937**	**29,173**
	TRY	6,073,167	209,104	2,783,753	124,648	1,982,439	213,120	1,790,614	93,498	1,594,815	83,206
Outstanding	**FX**	-	-	523,611	5,304	456,657	5,669	379,143	4,381	331,025	3,929
	Total	**6,073,167**	**209,104**	**3,307,364**	**129,952**	**2,439,096**	**218,789**	**2,169,757**	**97,879**	**1,925,840**	**87,135**
Under Legal	**TRY**		3,623		2,767		1,583		1,693		430
Follow Up	**FX**		0		561		213		108		25
(Foreclosure)	**Total**	**1.73%**	**3.623**	**2.56%**	**3.328**	**0.82%**	**1.796**	**1.84%**	**1.801**	**0.52%**	**455**

Source: BAT

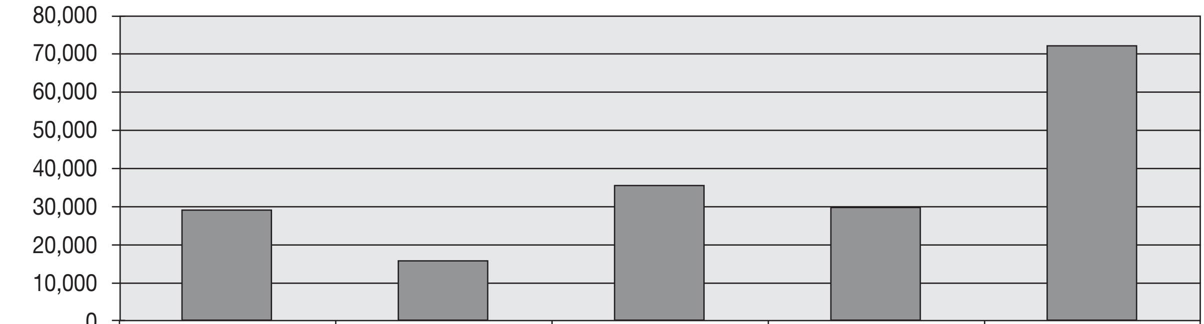
Graphs 3 and 4: Breakdown of home loans as a subset of consumer loans

Home Loans Extended (1,000 TRY)



	June 2004	Sept 2004	Dec 2004	March 2005	June 2005
Series 1	890,937	528,625	656,621	1,331,007	3,070,679

Number of Borrowers Per Quarter



	June 2004	Sept 2004	Dec 2004	38,412	June 2005
Series 1	29,173	16,394	35,240	29,670	72,398

Source: Banks Association of Turkey (BAT)

III. Secondary Market Practices

Secondary markets for fixed rate products in Turkey have long been fully dominated by the government's borrowing instruments, crowding out others from the marketplace. Turkish banks have issued asset backed securities in domestic capital markets in the past. However, several amendments in the tax regulations made that infeasible from 1994 on. In recent years several Turkish banks have become increasingly active in securitizing their non-housing consumer loan receivables through off-shore vehicles. Yet Turkey still lacks a mortgage portfolio securitization experience. Consequently, at the present the entire credit, interest rate, and prepayment risks originating from housing loans are being borne by originating lenders in Turkey.

Lenders in Turkey fund the consumer loans through their savings deposit base. The average life of these deposits is still less than 6 months[4]. Funding loan products with 20-25 year terms through deposits with less than 6 months creates an immense maturity mismatch in the banks' balance sheets, which in turn imposes an inherent cap that limits the growth of the outstanding loan balance due to the risk management regulations in place. In order to minimize this mismatch, banks either have to increase the maturities in the liabilities side or decrease the asset life. Either solution could be achieved through proper secondary market practices such as on-balance sheet or off-balance sheet securitizations. With the current legal

[4] Banks Association of Turkey

environment, due to taxation and expenses, it is not possible to do a local on-balance sheet placement, which leads the banks to refer to off-shore off-balance sheet placements through certain special purpose entities. In case of off-shore placements however, the banks' mortgage portfolios do not qualify for an acceptable rating which forces them to provide for extensive credit enhancement. This decreases the returns on asset securitization, thus making it less desirable. The best solution for having the mortgage assets divested through proper secondary market practices is to securitize locally, under fair competition, with certain tax incentives (such as witholding tax, explained later), to local investors like banks, pension companies and insurance companies, through an on-balance sheet securitization. Off-balance sheet securitization is currently not defined under the Turkish legal system; however it is expected to be, with the upcoming regulation.

Institutions with long term liabilities such as life insurance and private pension companies in Turkey are also seeking alternative tools to invest in, in the mid-term, in view of diminishing returns on government debt instruments.

The public and private sectors in Turkey are clearly focused on developing a robust and liquid secondary mortgage market This is evidenced in a 2002 directive outlining the requirements for purchasing loans, as well as the industry task force that has been examining the regulatory environment for mortgage lending and securitization. Primary market institutions have been disclosing strong interest in participating in a secondary mortgage market and a willingness to develop infrastructure supporting that. In order to create sizeable mortgage assets to be securitized, the banks will have to enhance their primary lending activities. However, currently, the lending institutions are limited to extending fixed rate home loans with very limited standardization of documentation, guidelines and appraisal services. Although the rates have come down to 13.5% with 30 years of maturity from 26% with 10 years maturity earlier this year, the rates are still high (as compared to the inflation rate of 7.54%) to promote fixed rate products. Besides, the banks are lending at rates below their cost of capital, taking the risk of writing off losses for a few months, expecting to generate profits as rates continue to fall. If outstanding mortgage portfolios reach an acceptable level of quality and magnitude, with fair taxation, lenders will be able to securitize these assets locally as the government's domestic debt requirement is expected to diminish.

Under Turkish Law, there is no concept of a trust or a true passive Special Purpose Vehicle into which an originator of mortgages can transfer assets and have them be bankruptcy remote. Yet there is a precedent for asset segregation within a corporate structure, as Capital Markets Law permits the isolation of assets for mutual funds. Hence, isolation of mortgages may be achieved without a fully-fledged transfer to a Special purpose entity (SPE) or trust (if a similar regulatory structure could be established that encompasses the isolation techniques that mutual funds currently use). However, it is unclear whether the market would accept this solution.

The general reliance on International Financial Reporting Standards provides a sound framework for secondary mortgage activities. Moreover, these accounting standards are common to many countries with successful secondary mortgage markets.

However, there is a lack of standardization and mortgage specialization in the primary market. It is not clear if there are sufficient originations to support sustainable large-scale secondary market operations. Lenders are currently limiting their originations to upper- and upper-middle class borrowers only.

III.a. Current Regulatory Framework for Secondary Mortgage Markets

Instead of a single law, the housing finance system in Turkey depends on several laws, including foreclosure and bankruptcy, consumer protection, capital markets, tax, and banking laws. Certain aspects of each of these laws and regulations bring forth some serious impediments against a robust mortgage system in Turkey and have to be redesigned to a way that first of all promote the primary market which should be followed by secondary market practices to link the funding side of home loans to the capital markets.

The impediment associated with foreclosure law is mainly related to the enforcement practices. Although the law of foreclosure and bankruptcy is very extensive, high inflation and unpredictable interest rates have lead delinquent borrowers to use their legal rights to place an objection[5], in order to delay the foreclosure process. Historically, the liquidation of Turkish mortgage assets took up to three years. With these implementation problems in place, banks typically prefer to work out the debt with the delinquent borrowers to restructure before filing a case. Since the delinquency rates in home loans have remained below 1% for the last 20 years, the foreclosure losses remained quite negligible on the banks' balance sheets. However, historically the typical borrowers were members of upper-middle income families with better payment willingness and capability. The significant growth in originations, as depicted in the previous sections, is expected to bring about a penetration into the less favorable market segments, increasing the delinquency risk (or credit risk). Although low inflation rates are expected to reduce the delinquent consumers' motive towards delaying the process, the above-mentioned implementation practices still exist.

[5] Consumers' Right to Object: This refers to the right to object to the foreclosure court processes that the borrowers have. Typically the fees and expenses of objecting to court decisions are either equal or less than the cost of capital itself. Coupled with the devaluation of nominal amounts owed due to high inflation, the borrowers tend to deal with their payment obligations as late as possible, especially if the value of the real estate asset is appreciating, which is the expected case under an inflationary environment.

In order to be able to increase the market size by penetrating lower income segments there shoud be primary market products for households with different payment capabilities. Adjustable rate and indexed mortgages are the main products that would serve this purpose. Before the consumer protection law was released in 1995, adjustable rate mortgages were extended by several banks which has created an understanding of these types of products among the consumers. However, Turkish Consumer Protection Law now prohibits the extension of such loans. Only Housing Development Administration, by a special incentive given by the relevant government entity, can extend ARMs, which are highly demanded by the public in general at the moment. Certain concepts inherent with the ARMs such as increasing the outstanding debt balance or the debt not amortizing itself over the maturity due to the differences in the indices, create confusion among the borrowers from time to time, but there seems to have been a quite effective learning period both for Housing Development Administration (HDA) and the borrowers. Having only the fixed rate instruments to use, the market development would have been very limited.

The Consumer Protection Law also means that the lending institutions are equally responsible with the building developer itself for product deficiencies and late key delivery in campaign product sales which are associated with certain building projects, thus causing the lenders to act sceptically in their marketing practices.

Prepayment penalties, on the other hand, are also against the Consumer Protection Law. To maintain a high level of investor interest in the mortgage backed securities, prepayment risk should be minimized. A prepayment penalty on fixed rate mortgages is one way of doing so.

Another method of hedging the prepayment risk is to create subordinated tranches of mortgage securities which should be handled by the underwriters themselves. There is no detailed description of subordinate structured debt instruments in Turkey. The Capital Markets Board should eventually draft secondary regulations regarding the subordinated securities.

Currently there is no defined standard of real estate appraisal services which the banks adhere to. Although there is a commonsense on the methodology, some dominant banks utilize in-house appraisers who do the valuation quite conservatively resulting in very high LTVs. On the other hand most of the banks utilize external real estate appraisers which leads to a lower LTV (around 70%). The external real estate appraisers have not been following any specific set of guidelines. In 2004, the Capital Markets Board issued a regulation for governing the conduct and practices of real estate appraisal companies. All the appraisal companies and appraisers will eventually need to obtain a license from the Capital Markets Board in order to perform appraisal services in Turkey. Since this is a very recent regulation, the number of licensed appraisers and companies are still very limited. Therefore, for a limited time, the banks will be free to use whichever company they choose for appraisal services.

There should be a set of guidelines to underwrite home loans. This requires a detailed description of origination, lending and servicing practices, such as consumer rating, using front end and rear end ratios, adequate documentation and reporting, etc. These should be identified through secondary regulations if not by the act itself.

Tax incentives are crucial for fostering the lending activities of the banks and creating a demand for secondary market products. Against some theories which propose a decline in real estate related tax returns, in practice, some amount of tax deduction may in fact generate an increase in tax returns due to an increased volume of transactions. At the moment there are a number of taxes and fees incurred with primary and secondary housing finance practices, namely, banking resource utilization support fees, banking insurance transactions fee, stamp fee, title fee, income tax (on MBS issuance and MBS investment), corporate tax on various housing finance institutions, issuance fees, etc. As of 15 October 2005 the types and amounts of tax incentives are still being discussed at the parliament level.

III.b. New Regulation: Amendments in Certain Laws Regarding Housing Finance

The new regulation encompasses a set of amendments in several laws mentioned in the previous section. The draft bill is expected to be passed through the parliament by November 2005 to be in effect as of January 2006. The comments below are based on the draft as of 15 October 2005, as the draft can be altered during the parliamentary process.

The amendments envisaged in foreclosure and bankruptcy law are mainly concerned with reducing the delay in the process caused by the delinquent borrowers posting legal objections. In addition to decreasing the lapse times during which the delinquent can post objections, the fees associated with making the objections are also increased by the new regulation, discouraging objections. If the bank loses the case, all the fees and expenses are to be borne by the bank. However, if the objection is posted only for time-gaining purposes, it will be costly for the delinquent borrower.

With the new bill, the borrowers will also be able to borrow against their existing real estate property. Currently, home loans are extended only to borrowers who are involved in a real estate transaction at the title office. However, the borrowers will be able to borrow home equity loans as long as that is their first or second home. By home equity loans the real estate tax collections are expected to increase significantly, as the borrowers would need to update the value of their properties at the title offices. The income tax deduction facility on home equity loans is still being discussed.

The Consumer Protection Law is expected to be amended in two ways: First, adjustable rate and indexed mortgages will be extended by inserting an exception within Consumer Protection Law. The lenders will be able to develop any kind of ARM and DIM depending on the willingness and ability of the borrowers to pay. Secondly, the absence of a prepayment penalty mechanism on fixed rate instruments will be removed for MBS issuance purposes.

There will be tax benefits on the borrower, issuer and investor sides. Some of these benefits are expected to be aplicable for all parties and some on relevant transactions. Tax incentives on stamp duty, the banking resource utilization support fund, banking insurance and title registration fees are applicable to all the relevant parties. There is still an ongoing discussion among the relevant governmental agencies about the tax concession to be given to the borrower, through income tax deduction. A tax return over the interest portion of the monthly installments is a very important and necessary subsidy to be undertaken by the government. This incentive will allow that segment of the population which benefits from institutional means of housing finance to grow; the homeowners who have utilized institutional housing finance facilities (such as bank loans) are currently 8% of the total homeowners. The MBS issuers and investors are expected to benefit from corporate tax incentives on their issuance and interest rate incomes respectively. This specific tax benefit does not have a direct effect on the primary home loans market but is very crucial for the secondary market development. Since the MBS market will be the first non governmental secondary market instrument which will provide funding to lenders from the capital markets, certain tax incentives, such as withholding tax, corporate tax, stamp tax and some other fees and duties might be beneficial in order to attract investor appetite.

Although a regulation for private sector secondary market instruments exists, it was mainly obsolete due to taxation and crowding out effects. As real interest rates decrease along with the public sector's borrowing need, private entities will be able to issue debt instruments given that the rules of competition are fair and equal. Starting from 1 January 2006 a witholding tax on government bonds will go into effect, putting private and public sector borrowing on an almost equal footing from the taxation perspective. It is expected that other fees and taxes would also be set in same proportions for all instruments regardless of the issuer.

Since the main players of mortgage business are banks in Turkey, they are likely to be the issuers of first mortgage backed securities. Since the concept of a trust and trustee, which is defined in the Anglo-Saxon legal system, does not exist in Turkey (which has a legal system derived from the Roman system of continental Europe), and cannot be defined by simply amending some law, the definition of a trust vehicle has to be done through creating a new law and changing the Civil Law along with it. This remains one of the long term targets of the government entities. For the time being the passive special purpose vehicle function will be performed by mutual invesment funds. For the purposes of mortgage assets, they will be named as mortgage investment funds. These funds, just like the existing mutual funds established by banks on their balance sheets and managed by portfolio management companies, will be established within the banks' balance sheets, with no equity capital. The income statements will comprise cash flows generated by the underlying real estate assets. They will be bankruptcy remote just like their trust and covered bond counterparts. The rules and regulations with respect to the creation of asset pools, mortgage investment funds and managing the underlying assets will also be governed by the secondary regulations which are to be subsequently issued by the Capital Markets Board.

Apart from the banks issuing mortgage backed bonds (mortgage assets investment fund shares), the concept of a conduit will be introduced with the new regulation. The conduit type incorporations are named as "mortgage finance institutions" (MFIs). MFIs will be allowed to operate in a variety of ways, however two of them are expected to form the core of business: "Central home loan bank" and "private conduit" strategic business units. As a home loan bank function, the MFIs are expected to issue debt instruments to raise funds which then will be channeled to the commercial banks for home loan purposes. As a private conduit, the MFIs are expected to buy out the confrming mortgage assets of the comercial banks, underwrite and securitize. The similar trust-like vehicle will also be utilized in the securitizations through MFIs.

III.c. Deficiencies of the New Regulation

Although it will provide crucial remedies to certain outstanding impediments against a robust mortgage system there are still certain amendments to be made.

First of all, the consumer protection law puts the banks under a similar scheme of responsibility with the constructor in the case of project based home loans. In other words if the banks offer special loan packages specifically geared towards a specific housing development project, they are as equally responsible as the developer for compensating for losses due to late key delivery or faulty production within 5 years after key delivery.

In order to build up a portfolio of mortgage receivables backed by securitizable real estate collaterals, the banks will prefer to extend home loans to homes with standards above average. In Turkey, these homes are typically found in certain development projects built by reputable constructors. However, the fact of being equally responsible with the constructor will definitely not help the banks. The definition of this responsibility should be loosened up, at least to put the lenders in a slightly less responsible position than the constructor, as they have to deal with a number of other commercial risks too.

Insurance is a very crucial aspect of a mortgage lending scheme. The insurance industry in Turkey is quite advanced and the current regulation is adequate to develop any kind of insurance policy. However, since the premiums are still high, any insurance policy which would add extra basis points on the interest rates are not welcome. If not a full coverage, partial mortgage insurance coverage should be added to the origination guidelines. Since long term home loans do not have a long credit history in Turkey, this type of a partial coverage will increase the rating of the mortgage pool to be securitized.

Although a vast majority of the lenders in Turkey are commercial banks, leasing companies are also considered to be mortgage lenders by the upcoming regulation. Leasing companies are subject to a different set of rules and regulations which provide them with certain benefits which may cause unfair tax advantages against the banks. While drafting the secondary regulations special attention must be placed on making all the lenders subject to the same set of rules.

IV. Conclusion

With decreasing inflation and interest rates, home loans are likely to get more affordable. However, this will take some time. Against all the expectations, the upcoming regulation is a set of amendments in some existing laws and regulations to remove some of the impediments which could, in the future, set a barrier against an efficient mortgage lending scheme. For the time being, the amendments seem fairly adequate; however, they are likely to be in need of further improvements in the future. At this point, secondary regulations, which will follow the primary regulation, may be formed to fill in the gaps, This would decrease the need for further amendments.

Needless to say, the housing finance system in Turkey presents one of the most exciting market opportunities of our times.

Housing Finance Models and Standards in the Republic of Croatia

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1. Introduction

The Republic of Croatia is a sovereign, independent republic, established as a parliamentary democracy since 1991. Its governing structure is based on a principle of the distribution of power among the legislative authority (the Croatian parliament), executive authority (Government of the Republic of Croatia) and judiciary (municipal courts, country courts, commercial courts, the High Commercial Court, the Administrative Court and the Supreme Court). The power is decentralized by virtue of the constitutional right to local and regional self-administration. The country's territorial organization includes 20 counties and the City of Zagreb (the capital) with a total of 123 towns and 425 municipalities.

As a new independent country Croatia is going through a complex process of transition toward a market economy. The main objective is the establishment of a welfare state and to achieve it, it is necessary to improve the efficiency on the macroeconomic as well as the microeconomic level as much as possible, and to raise the living standard and reduce inequality among citizens.

The general urbanization level (ratio of town residents to the total population) stands at 51.09% and is expected to rise further. In line with the trend, the urbanization level is expected to reach 75-80% by 2015. The average population density is relatively low at 78.39 residents per sq km. The fact that towns represent the main hubs of employment is among the reasons that 16% of the total population lives in the metropolis

Table 1. Land Indicators

Land area (km²)	56,542	Residential land (km², % of the total):	7.65%
Coastal sea (km²)	31,067		
Islands:	1,185	Inhabited Islands:	47
Capital:	Zagreb	National currency:	Kuna (HRK)

Source: Central Bureau of Statistic

Table 2. Macro Economy

		2002	2003	2004
GDP (at market prices)	(million USD)	22,812	28,810	34,311
GDP - year-on-year rate of growth	(in %, constant prices)	5.2	4.3	3.8
GDP per capita	(USD)	5,134	6,486	7,724
Unemployment rate	(% of labor force)	22.3	19.2	18
Inflation rate	(in % end of year)	1.7	1.8	2.1
Gross savings rate	(time and savings deposits as % of GDP)	63.6	69.2	69.5
Monthly average net wages	(in USD; end of year)	520.6	643.9	740.3
Exchange rate	(HRK : USD; end of year)	71,457	61,185	56,368

Source: Central Bureau of Statistic and Croatian National Bank

[1] The opinions presented in this article are those of the author and are not necessarily held by the Hrvatska poštanska banka d.d.

(City of Zagreb). Out of the total housing units in 2003, 67.03% were in towns and 15.6% of the total population were day migrants (or commuters).

Croatia's demographic picture based on the facts collected in the 2001 census can be described as less than satisfactory: senior citizens prevail in the population and the number of deaths exceeds the number of births (the population is shrinking).[2]

The Croatian economy recorded solid growth in 2004 (slightly weaker than a year earlier) which, along with the total outstanding external debt (reaching 88% of GDP) and balance of payments and fiscal deficits, was the main characteristic of the macroeconomic situation. Construction, which was the activity with the strongest growth in 2003 (primarily thanks to intense investment in the road infrastructure because it was stressed as a top priority of the Government's economic programme) declined in 2004, while the strongest growth in 2004 was achieved in industrial production (especially electricity, gas and water supply). Among the monetary developments it is interesting to point out that the Croatian National Bank (CNB) enforced certain measures in 2003 aimed at curbing the credit expansion (after a 39.9% credit expansion to non-financial institutions in 2002 and 19.0% in 2003), so 2004 credits to non-financial institutions grew 14.2% (with the financial activities of non-banking institutions, eg leasing etc growing at the same time). Also, there has been an evident increase in the credit exposure to households (household credits rose 46.8% in 2002, 27.7% in 2003, and 19.1% in 2004).[3]

In April 2004 Croatia received a positive opinion of the European Commission. It became an official EU candidate two months later, and the negotiations on accession to the EU started in October 2005.

2. Housing supply and demand

The data available on the number of housing units, households and population might lead to a conclusion that there is no lack of housing. However, even a rough analysis shows an evident over population of a number of dwellings (as several households sometimes inhabit the same dwelling) as well as a considerable shortage of housing in large centers/towns, low housing standards (the average housing area was just 27.6 sq m per person in 2001, etc)[4] and strong demand for social housing, while a number of dwellings are in need of renovation (eg 7.2% of inhabited dwellings lack sewage, 6.3% have no water supply and some 14% have no WC or bathroom). All this considering, the demand for the purchase and renovation of housing is expected to grow in the future, and so is the demand for home financing.

There is a shortage of urban housing stock, especially in the four largest agglomerations. Estimated shortage for the Capital of Croatia - Zagreb is about 45,000 housing units. Dwelling stock that is still in the hands of local authorities (social housing) is in very poor living condition. The part of urban dwelling stock which was previously owned by the state and was mostly privatized with the beginning of transition has a problem with maintenance (eg the roof leaks, façades are falling off etc). A remarkable part of the privatized housing stock needs serious investments and renovation. War damage during the recent aggression on Croatia contributed to an erosion of housing standards as 135,000 dwellings were destroyed between 1991 and 1994, worsening the living conditions of numerous displaced persons and refugees. A total of 12,580 units were completed in 2001, down 21% compared with 2000, while the number of dwellings built since 1996 is largely a result of the renovation of housing destroyed or damaged during the war. The number of dwellings built each year still lags behind the pre-war period (in the 1980s, 20-30,000 units were being built annually). Resolving the housing problems of the Homeland War victims and the reconstruction of destroyed dwellings was set as a priority of the housing crisis resolution by the Croatian government. All the structures damaged in the war should be rebuilt by 2006 as part of a programme entitled “A Roof for Each House”.

A recent survey on social issues with a representative sample on national level indicated 20% of respondents needed more housing space; 27% of cases had finished housing; 24.9% had finished doors and windows; walls and floors were finished in 21.2% of cases, while 14.5% indicated a problem with humidity in flats.[5]

The rented housing market is poorly organized and the exact number of tenants is difficult to determine as a large number of people who let housing do not report this officially in order to avoid paying tax. Around 37,000 households in Zagreb alone (or 13.5%) have the status of lessees (tenants), paying a monthly rent of 5-7 EUR per sq m[6]. Furthermore, large cities have a considerable number of dwellings with several rooms inhabited by the elderly, so this points to insufficient and inadequate programmes of care for senior citizens.

The first signs of stabilization in the region following the Homeland War brought about a considerable increase in housing prices. The average price per sq m of new-built

[2] According to the Ministry of Environmental Protection, Physical Planning and Construction 2003 Status Report for the Republic of Croatia, 23.7% of the population was young (between 0-19 years of age), mature population (between 20-59 years of age) represented 54.5%, while the old population (60+ years old) accounted for 21.3%.

[3] Source: *Banks Bulletin*, Croatian National Bank

[4] After: Fröhlich, Z., Bežovan, G. and others, 2001, pp. 10-13

[5] Centar za promicanje socijalnih nauka crkve, 2004

[6] Bežovan, G., Tepuš, M. M., Fröhlich, Z., 2004, p. 35.

dwellings in 2004 was between 10,450 kuna (in Zagreb area) and 7,831 kuna (in other towns), while the average monthly net wage totaled 4,173 kuna. A comparison of these amounts shows that an average citizen needed 1.9 – 2.5 monthly net wages for the purchase of a square meter of housing, ie financing the purchase of one's own flat or house from the regular income is impossible.

The latest figures released indicate an increase in the prices of housing in Zagreb and on the Adriatic as a lot of foreign buyers have appeared alongside local buyers, so a number of analysts predict that the prices will increase further.

In the absence of one's own funding, housing may be bought and financed by borrowing on the financial market. However, a large number of average Croatian citizens cannot meet the current criteria of commercial banks – the single market creditors providing long-term housing loans immediately.

3. Housing finance market and system

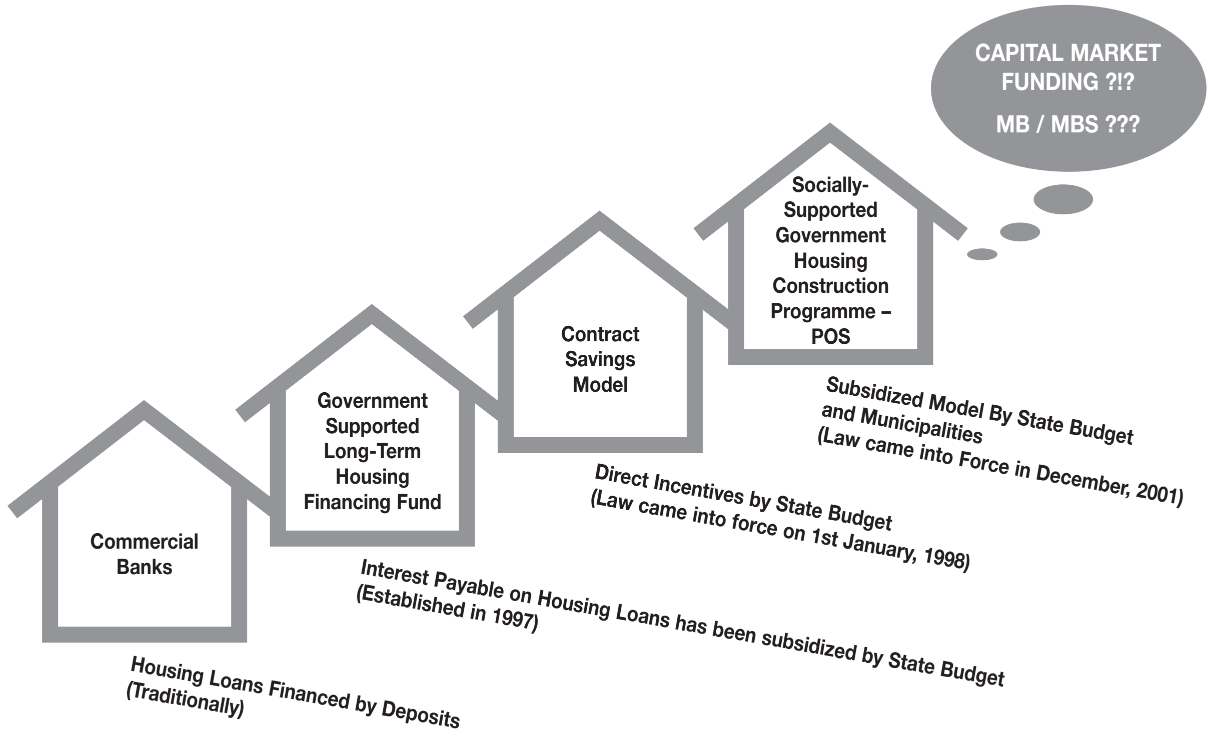
Organized housing financing in Croatia is the business of commercial banks and housing savings banks - HSB (ie, in German, Bausparkassen). Commercial banks often participate in home financing together with housing savings banks, and their products are included in various housing models (eg the government-subsidized POS model). The Government Supported Long-Term Housing Financing Fund was introduced in 1997 but has stopped functioning after just one year of existence.

The ratio of approved housing loans to the Gross Domestic Product in Croatia was 11.3% at the end of 2004, or relatively low compared to the European Union average.[7]

Basic data on housing financing products of the main creditors are shown in Table 4 and are explained in more details under following subtitles.

The Banking Law and the CNB regulations form the basis of the regulatory system of housing financing while the other key national legal regulations that govern housing financing issues are the following: Civil Law, Land Registration Law, Law on Ownership and Other Material Rights, Deed of Assignment Act, Bankruptcy Law, General Tax Law, Income Tax Law, Execution Act, Penalty Interest Rate Act, Draft (Bill of Exchange) Act, Trial Proceedings Act, Notary Public Service Act,

Figure 1. Development of housing finance market in Croatia



[7] The same ratio at the European Union level totaled approximately 40% at the end of 2003, and was particularly high in Denmark (70%), the Netherlands (more than 60%), as well as in Germany and England (more than 50%).

Table 3. Distribution of Granted Home Loans by Financing Model

		2002	2003	2004
TOTAL HOME LOANS	(In mil. USD)	1,742,96	2,792,20	3,862,32
	(Change in %)	53.93	60.20	38.32
	(%)	100.00	100.00	100.00
Market share - Banks	(%)	99.27	98.90	98.29
Market share - Housing Savings Banks	(%)	0.73	1.10	1.71
GDP (at market prices)	(mil. USD)	22,812	28,810	34,311
Home loans / GDP	(%)	7.64	9.69	11.26

Source: Croatian National Bank

Table 4. Typical Mortgage Products

Major products	Method of payment	Loan interest rates	Maturities	Borrowers	LTV	Others
1. Home loan of Commercial bank	Monthly instalments (amortization)	5.50-7.95% (adjustable)	mostly 15-20 years (possible up to 35 years)	Higher & middle-income households	up to 100%	Maximum payment/income ratio = 1 : 3; average loan amount 40,000-50,000 EUR; indexed to the EURO; deposits are requested (10-20%); co-borrowers (1 or 2) are allowed; guarantors (1 to 3) are requested ; real estate as collateral (1:1.3); loan fees 0.5-1.5% of the loan
2. Home loan of Housing Savings Banks	Monthly instalments (amortization)	4.44-6.0% (fixed)	up to 20 years	Households	up to 100%	Controlled use of funds; co-borrowers (1 or 2) are allowed; guarantors (1 to 3) are requested; real estate as collateral (1:1,5); deposit is requested (30-50%); indexed to the EURO; loan fee 1%

Foreign Currency Act and various CNB decisions or directives (eg those regulating a single way of expressing the effective credit and deposit interest rate, or a classification of bank credits and potential liabilities etc).

The business of commercial banks and housing savings banks is supervised by the CNB, along with the Ministry of Finance etc. (eg housing saving banks are also supervised by the State Auditor's Office).

3.1. Housing financing by commercial banks

Along with the process of establishing its independence the Republic of Croatia also embarked on a reform aimed at building an efficient, market-based financial system, transparent by international standards. The early banking regulations were drafted after those in Germany, while also taking into account quality solutions found in other countries. However, the inherited and current state of affairs at the time did not enable a complete "copying" of foreign models. The proposed legislation could not be such as to cause major "breakdowns" within the banking system, but at the time its provisions were supposed to influence banks to develop their business in line with the market rules.[8] After the Bank and Savings Bank Act was adopted in October 1993, universal-type commercial banks began to be founded and they nowadays represent the most developed type of local deposit financial institutions. The development of commercial banks has

[8] Leko, 1999

Table 5. Regulator and Supervisor

	Name of organization	Establishment	Main functions
Primary mortgage market (Lending and credit market)	1. Croatian National Bank	Independent from former Federal National Bank since 1989. Latest law in 2001	Central bank; Supervision Authority for Banks, Housing Savings Banks and Payment System; Banking regulation
	2. Ministry of Finance	-	State Treasury, Supervision, Regulator
	3. Money-Laundering Prevention Office	1997	Anti Money-Laundering Authority - Supervisor for payment transactions
	4. Deposit Insurance and Bank Rehabilitation Agency	1994	Deposits insurance (up to 17,740 USD) and bank rehabilitation
Secondary mortgage market (Funding market)	-	-	-

gone through various stages, and Croatia also had two banking crises.

There were 37 active commercial banks in Croatia at the end of 2004, and 31 of them had credits to households related to the housing loans granted to them.[9] Banks that do not engage in housing financing (6 of them) are smaller banks with individual assets of less than 850 million kuna, while their combined assets represent 1.0% of the total banking sector assets. At the end of 2004, the share of housing loans approved by commercial banks in their total assets amounted to 9.3%.

Total consolidated commercial banks' assets at the end of 2004 reached 225.6 billion kuna and stood 15.5% higher compared to 2003, or 105.1% higher compared to 2000.

The Croatian banking system is characterized by a significant presence of large commercial banks. The two largest commercial banks by asset size (*Zagrebačka Banka d.d. and Privredna Banka Zagreb d.d.*) account for 43.0% of the total banking sector assets, while 9 largest banks account for 89.99% of the banking sector total. The same 9 largest banks by assets size granted 97.02% of the overall housing loans reported at the end of 2004.

There is no organized trade in housing loans in Croatia, and banks engage in housing financing as portfolio lenders. Commercial banks encounter numerous problems

Table 6. Structure of Bank's Loans by Institutional Sectors

	1999	2000	2001	2002	2003	2004
Government units	6.41	8.01	6.59	7.26	7.76	7.21
Financial institutions	2.42	2.12	2.25	2.34	2.78	2.63
Public enterprises	3.73	4.60	4.43	4.09	3.67	3.96
Other enterprises	48.86	43.58	43.48	40.94	37.36	35.61
Non-profit institutions	0.44	0.57	0.25	0.33	0.31	0.31
Households	37.10	40.57	42.48	44.51	47.76	50.03
Non-residents	1.05	0.54	0.52	0.53	0.36	0.25
Total credits (%; mil. USD)	100.00	100.00	100.00	100.00	100.00	100.00
	6,095	6,280	7,884	12,916	17,995	22,212

Source: Croatian National Bank

[9] See: Kraft, Dolenec, Duliba, Faulend, Galac, Šošić and Tepuš, 2001, p.5, almost a half of all commercial banks offered no long-term loans early in 2000. Nowadays, long-term housing loans are available from most banks and the level of interest rate charged makes them most favorable since the country gained independence, ie since the beginning of transition.

related to housing loans, the most significant of which are an information asymmetry, ie insufficient information on retail clients (a credit register was established in 2004), and difficulties related to the valuation and use of collateral (property assessors, in bankers' opinion, are not focused enough on the market value; collection by seizure and sale of mortgaged property is difficult to implement and very often takes a long time).

It is evident from the share of housing loans in the total household credits that the absolute amount of these loans as well as their relative share in the portfolio of commercial banks is growing. The reasons for such developments lie in the following: stable growth of long-term savings deposits, fall of the interest rates charged by banks on housing loans, rise of living standards, loan security (loan service by retail clients has proven the best), improvements in property rights and judicial practice (eg fiduciary rights) etc.

Housing loans are currently offered on the local financial market at a nominal interest rate of between 5.50 and 7.95% (ie effective interest rate of 5.64 to 8.43%[10]) annually, and various credit worthiness criteria are applied.[11] The main criteria for obtaining a housing loan are a borrower's income (salary size) and the quality of the company he/she works for (the stability of its business is assessed). Depending on these criteria additional requirements may also be made (a borrower's own participation; co-borrowers and/or guarantors with appropriate income; certain type and amount of collateral – most often a housing unit worth at least as much as the loan amount to be approved[12], life insurance policy of the borrower tied over to the bank etc.).

Recently, some banks have issued housing loans indexed to the Swiss franc, thereby promoting lower interest rates (between 3.99 and 4.50% annually) and others have granted loans under a repayment-free model, with nothing but the interest repayable over the loan period while the respective share of matured principal is paid into an investment fund. Such products represent an innovation on the local housing loan market and their supply is currently limited, but it is expected to grow in the future. Up to now, there is no analysis made on national level about the risks arising from such products.

Refinancing housing loans from more favorable resources has had negligible scope in Croatia so far, although housing loan contracts include the clauses that regulate this issue, mostly providing for the payment of a certain fee (and interest rate re-charge for the period of taking a loan until the date of prepayment[13]). However, such a state of affairs is definitely influenced by the widespread practice of Croatian banks which, prior to approving housing loans, require that borrowers open current accounts with them for the payment of their whole salary (or other regular income) and do not approve housing loans before a certain period has elapsed (usually three months). Therefore, the choice of a bank to apply to for a housing loan does not depend exclusively on loan terms. Nevertheless, there has been some liberalization of loan terms in that respect as well lately, and it is sure to continue in the future.

Banks use their own networks of branches and outlets (these totaled 1,037 at the end of 2004) as the main distribution channel for housing loans, while the Internet is used first and foremost to inform clients on loan terms and documents that are necessary. Banks have yet to develop external credit brokers (Agents) as a distribution channel for loans. Some banks have opted to operate through such arrangements and we may expect this distribution channel to see further improvements in the future.

The characteristics of housing loans granted by commercial banks in Croatia are very similar, so we may speak about a certain standard of primary housing financing set by the banking industry which is applied throughout the country. For now, there have been no housing loans with the credit characteristics adjusted to particular groups of retail clients (so-called hybrid housing loans etc.) although there is scope for developing such products (eg for people who let private villas in the residential parts of towns and as well as numerous rooms and tourist apartments along the Adriatic coast etc.).

In view of a multiple effect of banking products that finance private housing projects of developers (as a component of the total cost, project feasibility factor etc.) it is necessary to point out, as part of the subject matter of this paper, that such products with their characteristics (loan period, required documents, collateral etc) are very often not adjusted to the needs of entrepreneurs/developers. This ultimately translates into less favorable terms for buyers as it also raises housing prices.

To finance housing loans, Croatian banks do not yet issue mortgage bonds or mortgage-backed securities, nor do they raise funding for this particular purpose in any other manner. The main sources of their housing funding are deposits and their own capital, with the EBRD special-purpose credits/ deposits and long-term syndicated loans used by some banks also worth mentioning.

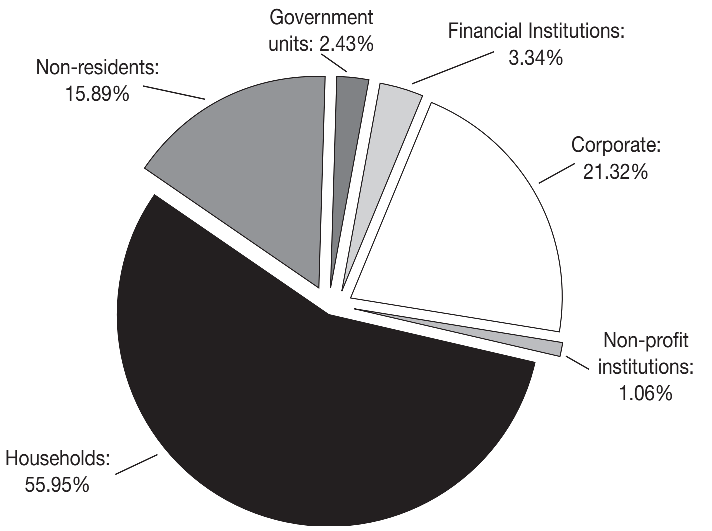
[10] The Croatian National Bank has set the effective interest rate, ie the unique method of calculation of interest rates that the banks have to present to clients and public, since 1st January, 2002.

[11] Almost all the home loans granted in Croatia are indexed to foreign currency.

[12] The mortgaged property has to be insured against fire, natural disasters etc. in the minimum amount equal to the loan amount (hazard insurance).

[13] Example of a home loan prepayment procedure of a bank operating in Croatia: the bank granted a home loan indexed to (EUR) foreign currency (amount: 87,500 EUR; interest rate: 7.5% fixed; monthly instalment: 654 EUR; repayment term: 20 years; secured by: mortgage, 10% deposit, 2 co-borrowers and 4 guarantors) and a client asked to prepay after 6 years of ordinary payments (654 EUR * (6 * 12) = 47,088 EUR). The bank charged 1.5% prepayment fee (919 EUR) on undue principal (61,251 EUR) and 16.328 EUR because of interest rate re-charge (because the total interest had been distributed over principal so that monthly instalment amounts the same over the whole 20 years of repayment).

Figure 2. Distribution of Deposits as at end of 2004 by Sectors (in %)



Most savings at commercial banks are denominated in foreign currencies (foreign currency deposits account for 36% of the total liabilities in the consolidated balance sheet of commercial banks) and are mostly household deposits. Toward the end of 2004, household deposits made up 55.95% of the total deposits.

When raising housing loans, retail clients are required to make a deposit of 10-20% (of the total loan amount) and some banks enable the deposit and loan processing fee to be subtracted from the disbursed loan amount. The deposit has a function of collateral and is often blocked in a special account for the whole loan period and bears no or very negligible interest. Recently, it has been possible to raise a deposit-free housing loan under partially changed loan terms, as banks may require a life insurance policy of the borrower, a larger number of guarantors and/or larger mortgage amount.

3.2. Contract Savings Model – Housing Savings Banks

Croatia, as a number of other countries at the beginning of the transition process, introduced a model to develop housing financing by engaging private citizens' own funds for the purpose of resolving their housing problems. It is a contract model of special-purpose savings with housing savings banks, similar to those in Germany and Austria (Germ. *Bausparkassen*).[14]

To regulate and help develop the contract special-purpose housing savings and financing model, the Housing Saving and Government Incentive to the Housing Saving Act was passed and came into force on 1st January, 1998. It enabled the establishment of financial institutions that specialize in housing financing – housing savings banks. Soon after this Act came into force, housing savings banks began to be founded, expecting a good acceptance in the market and solid business results. Three housing savings banks were founded in the first year after the Act came into force, and two were founded later. During 2002 two housing savings banks merged as a result of their mother-banks merger. The housing savings banks with the Croatian National Bank license operating on end of 2004 were: 1. *PBZ stambena štedionica d.d.*[15], 2. *Prva stambena štedionica d.d.*, 3. *Raiffeisen stambena štedionica d.d.*, and 4. *Wüstenrot stambena štedionica d.d.*

The Housing Saving and Government Incentive to the Housing Saving Act defined the terms under which housing savings banks may be established as well as their operations, the housing savings and housing loan terms, the terms, criteria and procedure of using state incentives for housing and penal provisions. Art. 20 Par. 2 Cl. 2 of the Act stipulates that a maximum agreed interest rate to be charged by a housing savings bank on a housing loan may not exceed the interest rate it pays on housing savings deposits by more than 3,0 percentage points.

The stimulation of housing savings by Croatian citizens is visible from direct incentives, i.e. budgetary funds allocated to all the housing savings banks in the amount equal to 15% of one's own payments into housing savings deposits over a previous calendar year. The basis to which 15% in state incentives is added is legally limited to 5,000 kuna (887 USD) at most, so a maximum amount of incentives a single housing depositor may get is 750 kuna (133 USD).[16]

An analysis of the operations of housing savings banks in Croatia since they were established reveals three distinct periods: a) the first did not allow for housing savings contracts with a protective monetary clause (which is often referred to as the "currency clause" in public)[17], b) the second period since 8th July, 1999, when agreeing the clause was enabled, making it the main

[14] The first housing savings banks in the transition countries of the region were founded in: Slovakia in 1992, Czech Republic in 1992 and Hungary in 1997.

[15] *PBZ stambena Štedionica d.d.* began operating early in 2003.

[16] The state incentives amounted 25% (1,250 HRK = 222 USD) of the same basis (5,000 HRK = 887 USD) before 2005.

[17] Currency clause means that a loan (or deposit) is indexed to foreign currency.

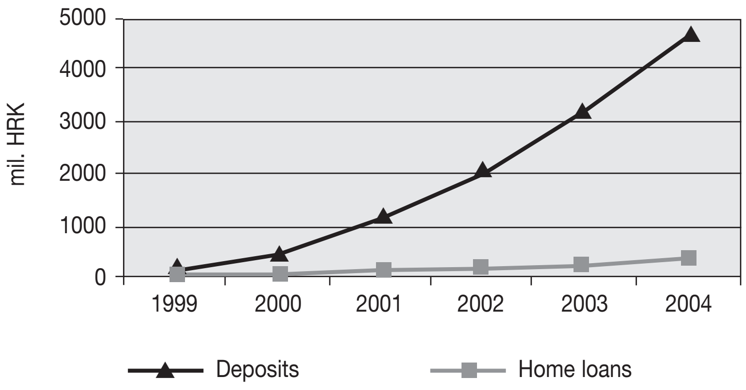
reason for a marked increase in the amount of savings deposited with housing savings banks in the following years, and c) the third period started from July 2005 with the state incentive reduction and de-regulation of Housing Savings Banks operation. By the end of 2004, housing savings banks had concluded more than 630,000 housing savings contracts with private citizens.

In order to win new depositors, housing savings banks have used the following distribution channels: 1) a network of their external salesmen – organized on various multi-level principles, with all the members motivated to sell by the commission paid on the basis of contracts they conclude with depositors, 2) their own and private licensed sales offices, 3) cooperation with and use of the distribution channels of banks (e.g. their counters and outlets), 4) the Internet etc.

Since the approval of an application for a housing loan before July 2005 was subject to a minimum of two years of purpose savings, housing savings banks began granting housing loans only in 2000, while greater credit activity as far as the number and total amount of approved loans is expected in the future.

Figure 3 illustrates a rift between the housing savings accumulated by housing savings banks and the amount of housing loans they granted in the period under observation, with their respective trend. Since a significant portion of loans has not yet "come up" for granting, in the circumstances of strong demand for housing loans housing savings banks have been placing the funds for other purposes defined by the law.[18] Before July 2005, under the Housing Saving and Government Incentive to the Housing Saving Act, housing savings banks were not allowed to engage in direct interim financing of housing depositors, but they have all developed a form of cooperation with commercial banks that enables them to offer a product with appropriate characteristics in the local market. Nevertheless, such a form of interim financing had imposed additional costs, while also hampering the development of this product and a whole area of housing savings banks' business policy. Therefore, instead of financing housing loans their credit potential was channeled into financing the government and its institutions through bond investment.

Figure 3. Overview of Deposits and Home Loans in the Housing Savings Banks Model



3.3. Socially-Supported Government Housing Construction Programme

A socially-supported government housing construction programme (known in Croatia as "POS" model) is the latest market incentive housing model, implemented in Croatia since 11th December, 2001, when the Socially-Supported Housing Construction Act was passed. This model is designed to resolve/improve the housing needs and conditions of households by engaging public funds (those of the government, towns and municipalities) and combining them with the funding of commercial banks and households. It is implemented through the construction of housing units organized so as to optimize the use of public and other funding for the coverage of costs, ensure its repayment and enable the financing of housing purchases on installment schemes, under more favorable than market conditions as far as the interest rates and years of repayment are concerned. The socially-supported housing construction model envisages the construction of flats provided that their maximum sales price does not exceed 910 euros per sq meter of the net usable area while the market price of a sq meter at the time POS model was introduced amounted approximately 1.400 euros (nowadays the market price amounts almost twice as much as the POS price).

Local self-administration units determine the housing needs and interest for the purchase of flats in their respective areas, and are under obligation to provide adequate building site with utilities and other communal infrastructure for this purpose. Those units also set the terms, criteria and procedure for determining the order of priority for the purchase of flats under this model.

If the flats under the POS programme are purchased on an installment scheme, the

[18] The lending policy of housing savings banks is regulated by Art. 10 of the Housing Saving and Government Incentive to the Housing Saving Act, which stipulates that the funds may be used for financing clients' housing loans, investment into the financial market instruments with first-class guarantees (deposits), as well as for the purchase of first-class sovereign securities issues and other securities issued with state guarantees or bank guarantees and placements with safe credit institutions.

buyers have to provide 15 percent of the estimated value of the flat as their own share (down payment), 45 percent is financed by a bank loan, while the Ministry of Environmental Protection, Physical Planning and Construction and self-administration units finance the remaining 40% of the value of flats. Each person buying a flat on an installment scheme has to meet the credit worthiness criteria set by the state Agency for Real Estate Affairs (APN) or a commercial bank providing the loan funds, and the flat being bought is used as collateral to guarantee the repayment of the entire debt including interest. After each such purchase the commercial bank loan is to be repaid first, followed by the remaining part owed to the Ministry and self-administration unit. The annual interest rate charged on the bank portion of the loan is 7.85% and is linked to the six-month EURIBOR, while the interest on the Ministry and self-administration unit's funding (40% of the flat's value) is not payable for the first 16 years and only a so-called compound interest at a 2% rate is calculated. Over the next 15 years, the loan is to be repaid at a 5% annual interest, and the total repayment time on an installment scheme may not exceed 31 year starting from the time a purchase agreement is concluded. The monthly annuity is set as an even amount over the entire loan period, but it may not be smaller than 0.25% of the total purchase price of the flat.

The social dimension of the described model is reflected in the provisions that provide an advantage in the purchase of flats to the households without adequate housing. Under adequate housing we understand flats of 35 sq m in size (with appropriate infrastructure) for a one-member family, plus an additional 10 sq m for each additional member of the household.

By end of May 2005, a total of 2,006 flats under the POS programme had been completed and delivered to their users, while another 2,240 flats are in various stages of construction. According to the data that has been published, 4,617 flat are currently being planned and the interest in further housing construction has been recorded. The new Croatian government, elected in November 2003, announced further improvements to this model of housing financing.

4. Concluding remarks

On the basis of an analysis of the housing financing models presented in this paper one may conclude that Croatia has traditionally been dominated by a deposit-based housing financing model, with commercial banks appearing as the main creditors, although new models and products that have emerged in the past few years are also being developed. As part of the moves to help households resolve their housing problems, the State-Supported Long-Term Housing Financing Fund Act, the Housing Saving and Government Incentive to the Housing Saving Act and a Socially-Supported Housing Construction Programme were adopted. Croatian citizens have shown particular interest in the housing savings bank products and the Socially-Supported Housing Construction Programme, while a state-supported long-term housing financing fund did not take off in practice.

The ratio of housing loans granted by commercial banks and housing savings banks to the Gross Domestic Product has been rising continually over the past few years (it stood at 11.26% at the end of 2004), so it can be expected to continue rising in the future thanks primarily to an increase in the living standards and more accessible financing.

Out of the total outstanding housing loans in Croatia, 98.3% were granted by commercial banks while housing savings banks granted no more than 1.7% of all housing loans. Housing lending is led by the banks with more than 5 billion kuna in assets, and they accounted for 89.99% of the total outstanding housing loans at the end of 2004. Most of the housing loans granted by Croatian commercial banks and housing savings banks are indexed to the euro. Nevertheless, the interest charged by commercial banks is for the most part variable, while housing savings banks grant loans at fixed interest rates.

Whereas mortgage (loss) insurance is very frequent and popular instrument of securing regular loan repayment by retail clients in many countries, very few insurance companies in Croatia offer or design such products. Nevertheless, it is certain that they will be improved in the future, and the Government might begin by setting the necessary standard and even introduce such instruments through its own institutions.

The operations of housing savings banks in Croatia, as well as those in a number of other countries, depend primarily on state incentives (premium) paid into individual accounts of housing depositors. The Croatian housing savings model could develop further through a process of deregulation of the housing savings bank operations, which would enable direct financing of developers' (housing) projects, investments in real estate and provision of some other banking services. During such a process, housing savings banks would assume many of the characteristics of banks so it is entirely possible that, some time in the future, they may start operating regardless of the existence or the level of the government premium.

The latest housing financing model (POS) bears a certain resemblance to the social housing programmes in Finland (as households are required to provide 15% of the funding) and France (since part of the responsibility for the programme is shared by the central and local government, with the local government units responsible for the urban and housing planning and preparing the sites for building).[19] Still, the fact that it is heavily subsidized by the government, apart from its "political charge", is a major shortcoming of this

[19] Similarities to social housing programmes in Finland and France are made based on the Tähtien, T. and Schaefer, J. P. articles in the Housing Finance International, vol. XVII/No 4.

model. Its development might be helped by structural changes to enable private sector investment and initiative, thereby reducing state funding for this model.

The rented housing market has not been part of the housing reform to date as far as the supply or the demand side is concerned, so regulating this segment might benefit all stakeholders.

When providing incentives to the housing construction, it would be vital to take note of the volume of construction work and the capacity of local builders, while also improving the accompanying administrative procedures and activities since stimulating measures on the demand side, while supply remains unchanged, are likely to lead to higher housing prices. The housing prices are increasing in the last few years, while the construction inputs and other costs have not changed sufficiently to prompt or justify such growth. However, if the purchase of homes is most often financed by the loan products of financial institutions, as is the case in Croatia (often up to 100%), it is right to wonder how realistic those prices truly are, whether a price bubble is being created and what might happen when it bursts. Such an outcome might provoke a financial system crisis, and this should definitely be taken into account when deciding on the housing policy measures.

The problems related to housing financing with the help of the models presented in this article have not been completely resolved since many citizens still could not meet the actual home loan terms set out by the banks. Most of the home loans are granted with fully variable interest rates and indexed to foreign currency. In addition, many Croats are taking home loans according to their current credit capacity (in amount as high as a bank is willing to grant) but the dwelling that could be financed in this way does not meet their needs (by size etc.). Therefore, a new cycle of housing financing, in witch larger dwellings (in better shape) will be financed, is expected to appear in the future. Because of presented trends and standards, it seems justifiable to launch an initiative for designing a national model to envisage resorting to the capital market as a source of funding for housing financing that will also limit the client's interest rate risk by introducing long term home loans granted with a fixed interest rate. To that end it is necessary to set the standards or criteria for granting housing loans on the primary market, establish an efficient and comprehensive credit register and a single register of pledged property, while also spurring the development of a system of housing loan repayment insurance (not vital). Certain laws (depending on the model to be developed) would also need to be modified and amended to make sure that the issues such as who may trade in credit portfolios and in what circumstances, are properly and accurately regulated. Licensing and establishment of legal agencies to take part in such a model would also have to be regulated, and Croatia would have to pass legislation governing national mortgage bonds (or mortgage-backed securities), and then set and supervise the minimum criteria that the securities issued on the basis of a mortgage pool have to meet.

Resolving the problems of housing financing is a complex task that depends on a number of national specifics so, when determining the national housing strategy measures and policies, conclusions should be made on the basis of the state of the housing sector and the current fiscal policy (particularly as far as tax relief, subsidies, state guarantees etc. are concerned). If Croatia were to embark on reforms so as to reduce budgetary spending on the existing housing financing models (mostly under the POS programme) and design new models (based on market principles), it would be recommended to include international institutions that have respectable experience with similar tasks (UN, World Bank, EBRD, specialized consultants, etc.) in the process.

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