Housing Finance and Regional Integration - Former Yugoslav Case: Could it Work?

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Introduction

The transition from a centrally-planned to a market-oriented economy has entailed different financial dilemmas in the countries of the former Yugoslavia[1], and housing finance is one of them. The change of the political system and the wars are among the reasons for recession and the collapse of the housing market (Pichler - Milanovich, 2001). During this time, housing policy was not a political priority (Tsenkova, 2003).

Today, these countries are characterised by high home ownership rates due to a privatisation wave of state owned property. However, housing finance is still progressing at a slow pace in most of the countries which still reflects the poor legal conditions and the lack of long-term funds. Besides the demand for modernisation and renovation of the existing housing stock, there is also a considerable need for new housing which is partly the result of an on-going migration from rural to urban areas in search of employment.

These changes require the creation of a sustainable model for funding home construction that is based on domestic sources, regional cooperation and foreign investors. The introduction of housing programmes will mitigate some of the basic problems that are a threat to the region, such as demographic problems and social stratification, which may produce long-term negative effects for the whole region and the European integration process, if they are not solved in a proper way.

Foreign direct investment, generally, does not flow from economically developed to less developed countries, but rather to other countries at a similar level of development (Ribnikar, 2001). EU integration has entailed or revived existing or new connections in this region, especially during the last five years. In all of these countries, a number of foreign banks (mainly from Austria and Italy) have been present with a wide range of new products and long-term credit lines. In some countries there are foreign credit lines and special housing and saving funds to support housing finance activities.

Over the last few years mortgage and housing loans have become one of the most important and most dynamic business fields in an increasing number of former Yugoslav countries. High growth rates on mortgage loans in relation to GDP are the main characteristics of these markets. However, these ratios are still below 10% (except Croatia) which is lower than the EU-15 average (34% in 2005).

Macroeconomic stability could support the development of housing finance. However, the creation of working housing finance mechanisms in countries in transition requires reforms of the legal framework and the introduction of new financial institutions and financial sources which will be in the centre of this paper. It will also discuss the role of regional and foreign banks, which are the main drivers of the integration into regional markets and the introduction of international standards and practices.

The region of former Yugoslavia

After World War II, the former Yugoslavia existed as a centrally-planned economy split into republics with a different level of independence in the last decade of the 20th century. The Disintegration of Yugoslavia was followed by wars which were stopped only with international support and peacekeeping forces. Afterwards, six independent states were established within the borders of the former Yugoslavia.

Previously a common market which comprised 22.8 million citizens, the region is now characterised by economic differences. Slovenia (the Republic in the North-West of former Yugoslavia) is most developed and is now a member state of the European Union. Croatia is on the list for the next round of applicants. The other Central and Southeast republics of the region are less developed: Serbia and Montenegro, as well as Macedonia, signed accession agreements with the EU. The rest of the region is in the process of negotiating conditions with EU authorities regarding stabilization and the implementation of the accession agreements with the EU.

Development differences increased significantly due to the harsh disintegration

[1] The former Yugoslavia encompasses Bosnia-Herzegovina, Croatia, Slovenia, Macedonia, Serbia and Montenegro. Albania does not belong to this group.

of former Yugoslavia. Whereas Slovenia now records a GDP per capita higher than several earlier member states, the level of development in the other countries still lags behind. Table 1 provides an overview on the basic data of the countries of former Yugoslavia. [2]

The economic outlook is good. Analysts from the IMF expect that the gross domestic product (GDP) will rise 4.5 or 4.8% a year (real) .[3]

Legislation

Due to the implementation and harmonisation with the legislation of the European Union the newly established states adopted new laws or adapted existing ones. As for housing finance, Serbia, Macedonia and Montenegro adopted a new Law on Mortgage, which defines special procedures for mortgage disclosure.
Serbia adopted a Law on a Government Agency for the Insurance of Mortgage Loans, with a mission to reduce credit risk for investors. Slovenia adopted a Law on Mortgage Bonds and Communal Bonds which is very similar to the German Pfandbrief law. .

Property registers could be a potential problem, as they should be electronically organized, with a high level of performance to track all the changes of ownership and a short time to accept mortgage rules. It can be expected that public registers, registers of real estate etc will be made up in an electronic form, providing necessary transparency that is essential for generating mortgage rights and conditions for values that equal to financial assets and liabilities. Some changes are evident in the region. The Croatian government decided to offer financial support to create a land and real estate register. Serbia arranged a non-interest loan with the support of the World Bank Group worth USD 30m which will be used to prepare efficient land and real estate registers. This project is of particular importance for the country since nearly half of the property is not registered. A similar problem is known in Kosovo.

Table 1: Basic data on former Yugoslavia 2005

	Area	Population in 000	GDP per capita in € (PPP)	GDP real growth %	Official Currency	Rating		CPI in 2005
						Moody	S&P	
Slovenia	20,273	1,997	18,900	3.9	SIT	Aa3	A+	2.5%
Croatia	56,542	4,439	11,000	4.3	HRK	Baa3	BBB-	3.0%
Bosnia and Herzegovina	51,129	3,850	6,140	6.5	C. Board	B3+	-	2.9%
Serbia	88,361	7,570	6,210	6.5	CSD	-	BB	16.2%
- Kosovo	11,300	1,800			€	-	-	
Montenegro	13,812	630	5,790	4.0	€	-	BB	2.5%
Macedonia	25,713	2,049	5,980	3.6	DEN	-	BB+	0.6%

Sources: Bulletins of Central banks, Ministry of Finance, S&P, WIIW, 2006

[2] On January 1, 2007 Slovenia will adopt the euro as its official currency. From June, 2004 Slovenia has been on the ERM 2 system

[3] IMF, Outlook, April, 2006

Housing stocks and needs

The housing stock in all parts of the region has been fully privatised. In some parts, it was destroyed during the conflicts and wars in the late 1990s. Most of it was rebuilt with the help of grants and domestic non-marketable government plans. Due to economic constraints during the transition period, housing construction decreased considerably.

Housing in the former Yugoslav countries has been characterised by underinvestment for more than 15 years. The total number of dwellings and number of new dwellings show that the golden years for housing construction were between 1980 and 1990. Table 2 shows the number of dwellings and new finished units from 1981 to 2004.

The table underlines the drastic fall in the construction in all parts of the region which is in contrast to the need for new housing. In addition, there is a great demand for renovation and modernisation of the existing housing stock. There is a regional construction boom in regions which offer potential for tourism. For example at the Montenegrin seaside, the number of dwellings rose from 6,245 in 1991 to 13,178 in 2003.

House prices and income

Housing affordability needs an acceptable relation between house prices and income. In this context, the region of the former Yugoslavia gave some specific relations, especially in the central and south eastern parts.
Official statistics are incorrect since they cannot take into consideration the level of hidden incomes, the false indication of sales prices in the sales contracts to lower property tax and the considerable amount of cash transactions. However, the statistics show that incomes are still low in relation to house prices (as indicated in table 3).

Table 2: Number of dwellings and new finished units 1981-2004.

	No. of dwellings in 000			No. of new finished dwellings		
	1981	1991	2001	1981	1989	2004
Slovenia	586	689	777.2	14,674	8,541	7,004
Croatia	1,381	1,780	1,876.1	30,439	20,341	20,358
Bosnia & Herzegovina	1,015	1,295		30,274	25,445	
Serbia	2,580	3,036	2,981[4]	57,166	48,274	16,388 [5]
Macedonia	436	549	698 [6]	11,678	10,864	4,468
Montenegro	131	207	253.1[7]	4,944	2,771	3,116
Ex-Yugoslavia/ Total	6,130	7,556 [8]		149,175	116,236	

Source: Official Statistic Bulletins former Yugoslavia (for years 1981-1991), National Statistics for the year 2004, own calculations

Table 3: Average square metre prices for newly built dwellings in capitals in 2004 and average monthly gross salary in 2005

State / Capital	Price m² in €	Average monthly gross salary in €
Slovenia – Ljubljana	1,360.2	1,151.7
Croatia – Zagreb	1,238.4	838.7
Bosnia and Herzegovina – Sarajevo		395.5
Serbia – Belgrade	1,248.7	317.5
Montenegro – Podgorica	803.6	326
Macedonia – Skopje	709.5	346.6

Source: Official Statistic Bulletins - conversion in € (official exchange rate) of central banks, WIIQ, 2006

[4] Census 2002
[5] Dates for the year 2001 excluding Kosovo
[6] Census 2002
[7] Census 2003
[8] Estimates for 1991 (the last year for this country)
[9] Prices for new finished dwellings on official statistics

Monetary policy and financial market infrastructure

After the disintegration of the former Yugoslavia, the new states established their new central banks as regulatory bodies in charge of monetary policy, and with the task to achieve a stable financial system. Whereas Slovenia[10] , Croatia, Serbia have their own currencies, Montenegro and Kosovo adopted the Euro as official currency. In Bosnia-Herzegovina, the convertible mark (BAM) is linked to the euro through a currency board.

Bank restructuring and privatisation is largely completed. The banking sectors are characterised by high shares of foreign ownership (mostly by Austrian and Italian banks). However, some banks from this region have become active in other countries of the former Yugoslavia. These banks are often interested in smaller banks. For example, there were ownership interests of Nova Ljubljanska Bank (NLB) in Bosnia-Herzegovina, Serbia and Montenegro, and Macedonia. Recently, Komercijalna Banka from Serbia invested in another bank in Montenegro.

The presence of foreign banks has been facilitated by liberalising the national banking sectors. The most dominant investors in the former Yugoslav countries are Raiffeisen, Erste Bank, Hypo Alpe Adria Bank from Austria (in Slovenia, Croatia, Bosnia-Herzegovina, Serbia and Montenegro). Italian banks (Banca Intesa, Unicredito-HVB-BA-CA[11]) are owners of banks in Slovenia, Croatia, Bosnia-Herzegovina and Serbia. Société Générale from France is the owner of SKB bank from Slovenia, Splitska Banka from Croatia, Podgoricka Bank from Montenegro and also runs a branch network in Serbia. Greek Banks (e.g. Emporiki Bank) are active in Serbia and Macedonia.

In some parts of the region (Croatia), the banking market in terms of ownership has been almost completely given up to the foreign capital (91%), while in the other parts of the region, except Slovenia, the presence of foreign banks is becoming increasingly dominant (Serbia, Bosnia-Herzegovina, Montenegro). The share of foreign banks is much higher than 75%.

All countries have inaugurated the establishment of stock exchanges. In Slovenia and Croatia, there is an active trade of shares and government bonds on the stock exchange, whereas in Serbia, the stock exchange is nearly not existent. Stock exchanges in Bosnia-Herzegovina (Banja Luka and Sarajevo), Macedonia and Montenegro (NEX Montenegro) use the stock-exchange trading system of the Ljubljana Stock-Exchange. The basic idea of the implementation of similar IT platforms on the stock exchanges is to create a regional link[12]. The main characteristic of all these stock exchanges is a lack of quality bonds and other debt securities, except government securities. In addition, they have not yet registered trade with mortgage related securities.

Investment funds were established only recently in the region. In Slovenia and Croatia, private pension funds are already active. There are two private real estate investment funds established in Croatia. Especially, pension funds face a lack of securities (primarily bonds) in which the collected capital of the savers can be invested. Government bonds are the only low risk alternative.

The insurance sector is less developed then the banking sector. A more developed insurance sector exists in Slovenia (insurance premiums were equivalent to 5.3% of GDP in 2005), followed by Croatia (3.2% in relation to GDP in 2005). In the other countries, domestic insurance countries dominate the market. The most active foreign insurance companies are Grawe, Generali and Allianz (mainly in Slovenia and Croatia).

Main characteristics of housing finance

Housing finance is rapidly growing in all countries. After 15 years of underinvestment, high demand for housing finance products is a result of macroeconomic stability, foreign banks' credit activities and rising competition in the local markets.

In some countries (Slovenia, Croatia), the growth of mortgage debt and housing loans is partly the result of government intervention. These countries also note a strong increase in house prices. Prices in the capital cities (denominated in Euro) grew on average by 4 to 7 percent a year between 1996 and 2004.

The main characteristics of banks' housing loans are:

- Annuity mortgage loans mostly with fixed interest rates
- Repayment rates are indexed to the Euro
- Standardised banking procedures,
- Mortgage as a collateral
- Terms vary from 10 to 25 years.

In the nineties, the typical mortgage (housing loan) was a ten-year repayment mortgage. The short mortgage term was the result of a relatively high nominal interest rate, which made long-term mortgages relatively unattractive. Most mortgages were offered with interest rates that were fixed above the level of inflation. The typical LTV (Loan to Value) ratio was quite conservative, at 50 percent, and the income criteria applied by lenders limited mortgage repayments to no more than 1/3 of the borrower's disposable income. Because of the country's high house prices and the low payment to-income ratios, LTV ratios were often far below the 50 percent threshold.

As a result of bank competition and better legislation, mortgage terms were extended from 10 to 25 years, interest rates were lowered and LTV ratios were higher (75-

[10] From January, 1. 2007 full adoption of euro

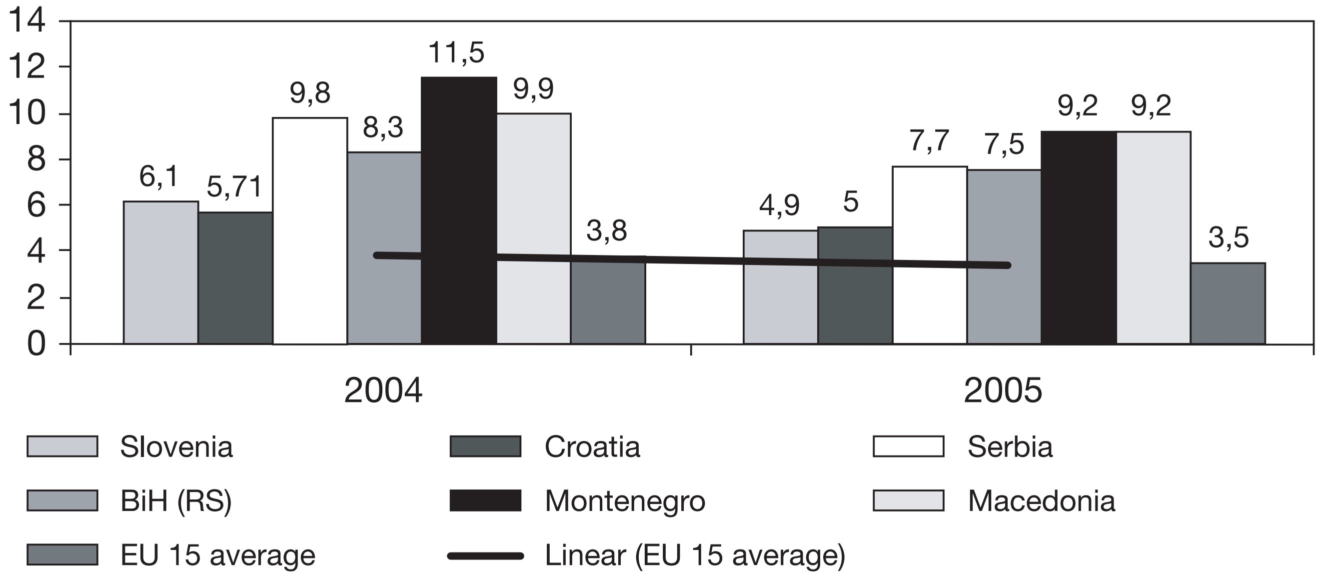
[11] After integration of the Unicredito Italiano and HVB, the management announced that the former Yugoslav banks will be managed by Bank Austrian Creditanstalt – BA-CA from its Austrian headquarter.

[12] Information and trading statistics could be seen at www.seem-on.net

80%). Payment to income ratios rose up to 50%. Often, banks took into consideration the whole family income.

Interest rates vary from country to country as figure 1 shows. Interest rates are still higher than the average interest rate in the EU 15 although the gap has narrowed (especially in Slovenia and Croatia). The main reasons for these differences are macroeconomic stability, access of "domestic" banks to foreign funds from foreign banks etc. Government intervention (mainly in Serbia) has also influenced the development of interest rates.

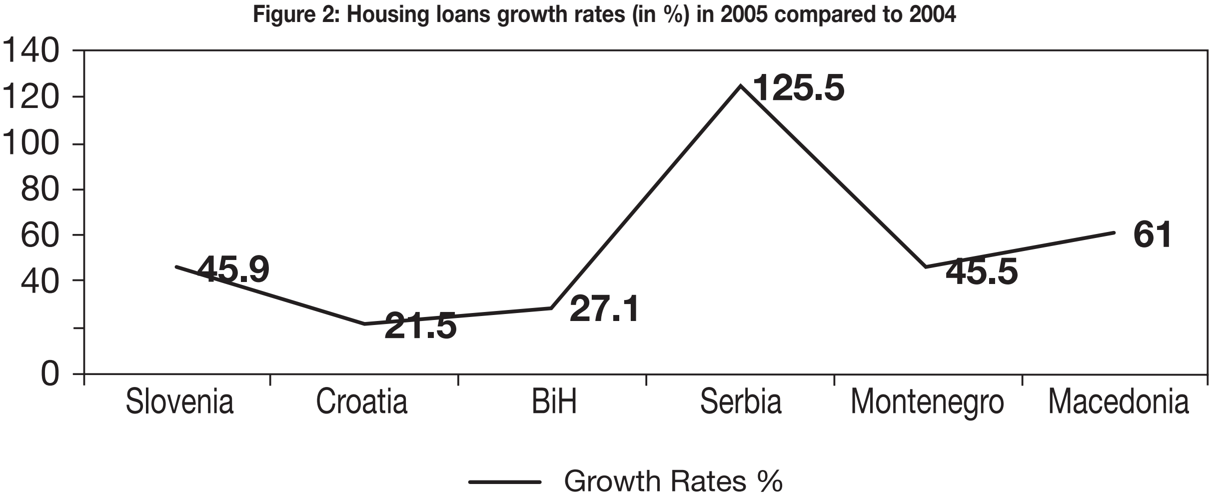
Figure 1: Average banking active interest rates on housing loans (in %) 2004-2005



Source: Central banks, own calculations, 2006

Figure 2 shows the mortgage loan growth rates in the former Yugoslav countries.

Figure 2: Housing loans growth rates (in %) in 2005 compared to 2004

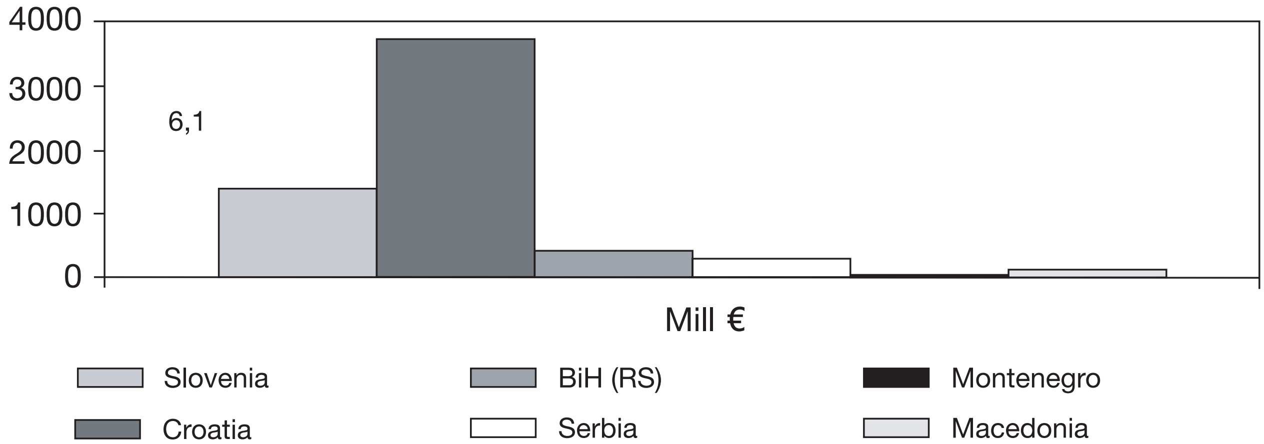


Source: Central banks, own calculation, 2006

However, the total value of mortgage debt is higher in the more developed countries such as Slovenia (EUR 1.4 billion) [13] and Croatia (EUR 3.7 billion) . In the other countries, mortgage lending started only one or two years ago. Double digit growth rates are likely in the next years. Figure 3 shows the value of housing loans converted into Euro at the official exchange rates of respective Central Banks.

The highest penetration of mortgage lending activities is recorded in Croatia and Slovenia with a share of 13.4% of mortgage debt to GDP and 7.2% respectively. Serbia and Bosnia and Herzegovina offer considerable potential for future development. In the whole region, experts reckon that total mortgage debt will rise to more than EUR 10 billion, a significant volume for securitisation which could eventually be organised through a central regional platform.

Figure 3: Housing loans in mill EUR on the end of 2005



Source: Central banks, own calculation, 2006

Potential funding sources

The increasing need for reconstruction of the housing stock in the region can be met only by creating a financing model that would be long-term and funded from stable sources. The model must be sustainable and have a clear strategy that is attractive to potential foreign financial investors.

However, domestic funds should be the primary source of funding. Specific-purpose funds for housing construction already exist in Slovenia and Croatia and they are mainly the result of the budgetary allocations for those purposes. The source of these funds is created through reallocation of financial assets obtained through privatisation of flats in the first years of transition.

Savings of the local population potentially represents the biggest initial source of income for this model. A high level of savings outside the formal banking sector exists in Bosnia-Herzegovina, Serbia, Montenegro and partly in Macedonia. The conversion of different currencies into EUR (2002) has shown that citizens have a large amount of savings. Conversion into EUR, reforms of the banking sector and market liberalisation have helped to increase the inflow of deposits into the banks, which provides an incentive for a more significant supply of housing loans.

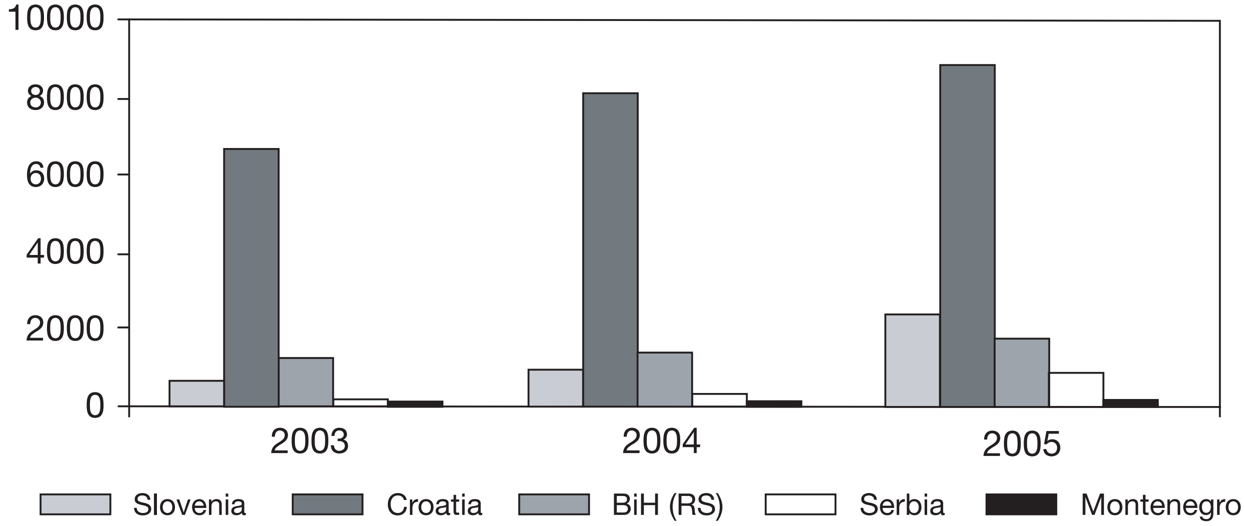
Some banks have access to specialized credit lines from foreign banks. As a result, net foreign liabilities of banks are in direct correlation to the growth of household loans and special housing credits as shown in figure 4.

Other funding sources are investment funds which have grown in importance. For example, in Croatia the total asset of 10 investment bond funds amounted to EUR 229 million at the end of 2005 The Slovenian fund industry consists of voluntary pension funds, mutual funds and investment funds. Financial institutions which collect voluntary pension insurance recorded an investment portfolio of EUR 592.5m (as per end of 2005). Over 40% of their portfolio is invested in government bonds. The life insurance sector is not yet an important funding source for mortgage loans (with the exception of Croatia and Slovenia). In Croatia, life insurance premiums amounted to EUR 254m in 2005 and in Slovenia to EUR 355m.

Household savings still do not constitute an important funding source for mortgage loans. As figure 5 shows, however, all countries record an increase in savings. The trend is to longer-term savings and in local currency.

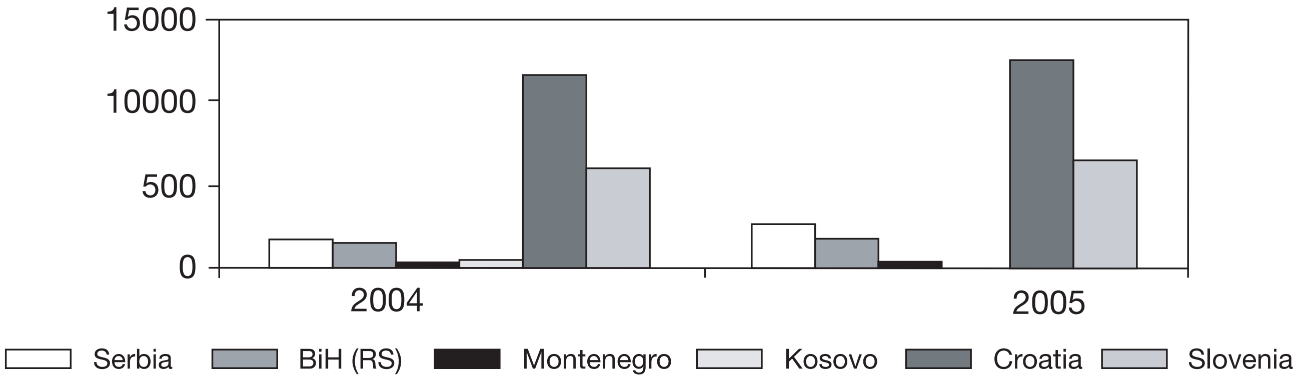
[13] Central banks dates – conversion in EUR on official exchange rates.

Figure 4: Net foreign liabilities of banks in mill EUR for the years 2003-2005



Source: Central banks, own calculation, 2006

Figure 5: Household savings in banks in mill EUR 2004-2005



Source: Central banks, own calculation, 2006

Further funding sources are remittances from relatives living mostly in western European countries (eg Austria, Germany, and Switzerland). According to World Bank estimates, for example, Serbia receives about USD 4.3 billion per year from Serbian people who live outside the country. A similar situation is observed in Kosovo, Bosnia and Herzegovina, Montenegro and Macedonia.

Government intervention

After privatisation of the once state owned housing stock, the governments of the former Yugoslav countries completely receded from intervention in the housing markets. However, in Slovenia, Croatia and Serbia, the state has introduced measures to support the development of housing finance.

In Slovenia, the governement established the National Housing Fund in 1999 which operates savings linked credit schemes with maturities of 5 and 10 years and preferential interest rates for the loan phase which is linked to the fullfilment of the savings phase. The savings plans are offered through the banking system.

The interest rate is 1.65% for the 5 years saving option and 3.0% for the 10 years savings option. Government subsidies are equal to 1/12 of the saved amount. Participants in the saving scheme are entitled to take up a housing loan which is two times higher than the saved amount. Interest rates are 2.45% for a loan with 10 years maturity and 3.80% for a loan with a 20 years maturity.

There is a similar, but slightly different model in Croatia. A part of the revenues in the state budget is allocated to encourage housing construction on the basis of a special savings plan. The Government provides a savings bonus to participants of this scheme. The savings schemes are modelled on the German bauspar system.

The savings schemes are offered through specialised institutions. Spending on the savings subsidy rose from EUR 25m in 2002 to EUR 48.2m in 2004. This increase incited the government to reduce the subsidy amount. In addition, the specialised savings banks are allowed to offer bridge loans for those savers which have not yet completed the savings period but would like to take up a loan.

With the introduction of these savings schemes, both the Slovenain and the Croatian government intended to improve housing affordability.

Serbia adopted the Canadian insurance housing credit model. The volume of new housing loans insured by this government institution in March 2006 was EUR 58m. The Montenegrin government made a campaign for interest rate subsidies which lead to reduction of the market interest rate by 2.4 percentage points (from 6 % to 4 %).

Potential problems

Realisation of this project could face a series of problems, despite harmonisation of the legislation and activation of citizen's savings.

Potential problems can appear for both credit beneficiaries and financial institutions. Stability of jobs and ability to repay long-term housing credits can be of special importance for the beneficiary.

Granting housing credits requires quality assessment of the borrower's creditworthiness. In a situation when in some parts of the region the income is relatively low and where there is a grey market, this phenomenon makes creditworthiness assessment very difficult. One of the solutions for such a situation could be a joint repayment of credits (joint liability for a loan by spouse, parents, etc). Many foreign banks offer this solution as a possibility and that is a way to reduce credit risk. People in the region are still attached to their families and younger people in the less developed parts of the region are still dependent on their parents.

Linked to the income instability are the high interest rates which have a negative impact on affordability. Although government support of savings schemes or mortgage default insurance may help to decrease the interest rate burden for the borrower, only broad legal reforms and rising competition will bring housing interest rates down (BeÏovan, 2004).

By resolving the problem of credit repayments and extending the repayment period, a regional agency for securing credits could provide a special incentive. Commercial banks would approve credits, while credit beneficiaries would buy insurance and thus minimize the risk of repayment and possible default.

Perspectives

The mortgage market in the region of former Yugoslavia could be an efficient instrument to stimulate saving activities. However, the creation and production of standardised credits, good repayment monitoring and securitisation of mortgage portfolios which could be sold to foreign investors would offer a promising path to increase housing finance in the region.

Having in mind the small size of these markets, it is evident that its perspective lies in its integration with international markets for loan and investment capital. Foreign banks that are more and more present in the region will become the main connection to foreign investors. It is likely that domestically owned banks will lose market share since they face difficulties in competing with foreign banks. Foreign banks would be the main drivers for standardised mortgage loan procedures which are a necessary prerequisite for the securitisation of mortgage loan portfolios.

Guarantee institutions are necessary and it is exactly the size of the potential regional market that can be the most attractive factor for establishing a "cross-border" guarantee institution, ie harmonisation of work and savings-guarantee schemes of the existing national institutions. Bigger regional banks of the former Yugoslavia could establish this type of institution. This institution should be established as a private public partnership (PPP).

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