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**Housing Bubbles
In the UK, Ireland and Spain**



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Editor's Introduction

by Friedemann Roy

Since 2002 The Economist has been tracing house prices, which allows readers of the journal to track the global residential property boom. In its edition of 7 December 2006, it noted that despite the deflating bubble in the U.S., house prices in other regions of the world were still simmering. Even in markets like Australia or Britain, where it once seemed that property markets had levelled off, prices had picked up again. As for Britain for example, the journal concludes that house price movements are in particular driven by expectations. Once they come down, real house prices are likely to fall. The trouble, of course, is predicting when.

The objective of this HFI issue is, therefore, to shed light into the debate on house price bubbles and their effects on the economy. A host of contributors reviewed their national housing markets and assessed the factors which have driven prices, thereby also looking at the overall prospects of the individual market.

Our first article is by Paul Samter, Economist, Council of Mortgage Lenders in the United Kingdom. In his article, he analyses the current debate in his country on how far the housing market interacts with the wider economy and with consumer spending in particular. Data suggest that prices and spending are only strongly correlated when they are affected by common drivers, most obviously by income growth and expectations.

The author of the second article is Jim Power, Chief Economist at Friends First, a financial services group based in Dublin (Ireland). He scrutinises the factors which have fuelled demand for houses in the Irish economy. Ireland's membership of the

European Union (EU), inflow of foreign direct investment and a governmental policy favouring home-ownership have been behind the surge in house prices. In his view, the market looks set to remain solidly based. Therefore, he does not expect major corrections in the near future.

The third article by David Nogales, Deputy Director Fixed Income, Gonzalo del Real (Director Risk Analysis) and Jesús Portomarín (Risk Analysis) – all with Ahorro Corporación Financiera, looks more closely at the Spanish housing market, which has also experienced considerable growth during the last years. Similar to Ireland, it seems that the country has benefited from EU membership, too. Another factor has been the adoption of a mortgage market law which allows for the issuance of covered mortgage bonds (cédulas) to finance mortgage lending. In this context, they describe a covered bond funding tool (AyT Cédulas Cajas) for the Spanish savings banks. Its structure appears to be similar to a conduit. In the next issues, we will also focus on markets in transition countries.

Recent feedback suggests a demand for discussion on regulatory issues in housing finance. As a result, this topic will be considered more intensively in the next issues. A first article which analyses the reform of the legal framework on mortgage lending, is presented by Ms Carol Rabenhorst, Senior Legal Advisor, and Nicoleta Mihalache, Consultant (both from the International Activities Center at the Urban Institute in Washington DC). At the centre of their debate are the Moldovan mortgage market and the current work of the Government to enact a new mortgage law to support market growth.

The last two articles build on previous HFI issues: the first one is by Yevhenia Dyad'ko, Dnepropetrovsk University of Economics and Law in Ukraine and Gary Roseman from the Economics Faculty at Berry College (USA). They provide an update on the Ukrainian mortgage market. Fuelled by rising incomes and growing supply of mortgages, the market will experience continuing growth. It could further accelerate if lenders' access to long-term funds would be facilitated. In this context, the creation of secondary mortgage market or the adoption of the covered bond model could offer a solution.

The author of the second article is N.O. Jorgensen, consultant on urban economics and finance based in Nairobi (Kenya). He provides a link on the last HFI issue on housing microfinance. He presents a model which could provide better access to housing to poor and low income groups. At the cornerstone of this model is the provision of bigger units with more bedrooms so that the owner can rent out a room for income generation to repay his or her mortgage loan (this scheme was briefly mentioned in Sally Merrill's article on "Expanding Microfinance for Housing in the last edition of HFI"). He does not give clear evidence about the success of this idea; however, it may provide some useful input for the discussion on this topic.

I hope you will enjoy reading the articles. Your feedback is more than welcome. I look forward to your comments or recommendations to roy@bankakademie.de.

Dr. Friedemann Roy

UK HOUSING AND THE ECONOMY

UK Housing and the Economy

By Paul Samter, Economist, Council of Mortgage Lenders

The housing market is extremely important to the UK economy, with a large share of household wealth and debt held in and against the nation's homes. The UK economy has been remarkably strong in recent years, and over the last decade house prices have risen by 180%. Housing demand continues to grow faster than supply and, with a strong economic backdrop, prices look set to continue to increase.

The UK mortgage market is highly competitive. The cost of servicing debt has declined dramatically since the early 1990s, as interest rates have fallen and competitive pressures have squeezed lenders' margins. There have been important developments in both the range of products offered and customers served by UK mortgage lenders.

The share of households who own their homes is not especially high compared to many other economies, but has risen continually since the second world war. Rising prices have led to high debt levels in relation to income, and made it progressively more difficult for new entrants to get onto the housing ladder in recent years. The private rented sector is relatively small, but has grown in the last five years and is likely to continue to do so, with investment buyers playing an increasing important role in this market. Changing housing preferences among young adults and growth in the number of single households suggest that this is likely to continue.

There is some debate over the way in which developments in the housing market interact with the wider economy and with consumer spending in particular. The view that higher house prices lead to increased

consumer spending through a "wealth effect" has been challenged recently, with evidence that prices and spending are only strongly correlated when they are driven by common drivers, most obviously income growth and expectations.

With high levels of indebtedness for recent borrowers and a relatively large share of mortgages on variable interest rates, changes in policy interest rates have a direct impact on much of the UK's borrowing population. Despite the rise in the popularity of fixed rate mortgages in recent years, most are fixed for terms of only two or three years before reverting to a variable rate.

Housing has recently risen up the political agenda. The Government has commissioned reviews of mortgage financing, housing supply and the planning system and is promoting shared equity schemes in an effort to help more people into home ownership. Increasing owner occupation and low cost ownership have become more prominent policy objectives

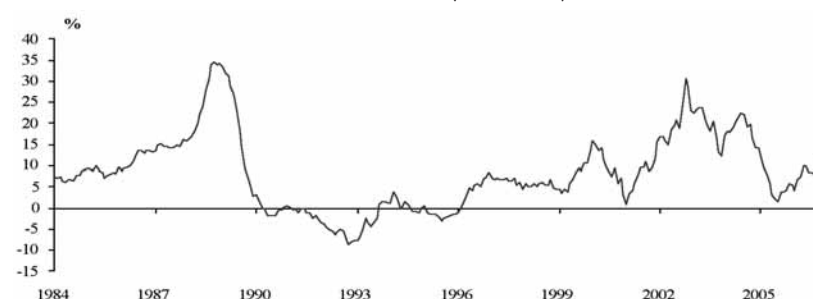
The UK housing market, finance and the economy

The performance of the UK housing market is clearly linked to the British economy as a whole. The last decade has seen continuous economic growth and house prices move ever higher. Since 1996 nominal house prices have risen by around 180% and by about 150% after accounting for general inflation, while the economy has enjoyed continual growth since 1992. This is remarkably different from the twenty years from the early 1970s to the early 1990s when the economy was dogged by high inflation, high unemployment and volatile growth.

In the late 1980s the UK experienced an inflationary boom which saw house price growth peak at over 30% and general inflation rising to over 10%. The policy action taken to reduce inflation led to a recession, which became intertwined with falling house prices as many lost their homes or faced negative equity – where the outstanding debt on their mortgage exceeded the resale value of their home.

House prices fell by around 13% between 1990 and 1993. They then stabilised for about 18 months before falling by a further 4% between mid 1994 and the end of 1995 (see chart 1)¹.

Chart 1:
UK annual house price growth



Source: HBOS

¹ Calculation based on the Halifax House Prices Index.

UK HOUSING AND THE ECONOMY

In the more stable economic conditions since the early-mid 1990s, the nature of the mortgage market has been transformed and it has become an extremely competitive lending environment.

The development and increased sophistication of credit risk management tools has allowed lenders to segment markets more effectively and lend to previously under-served parts of the market. In recent years there has been considerable development of the "non prime" market, which focuses on customers with impaired credit histories. Lenders have increasingly taken individual borrower circumstances into consideration in affordability models when assessing how much to lend, rather than the more inflexible limits on loan to income ratios used in the past.

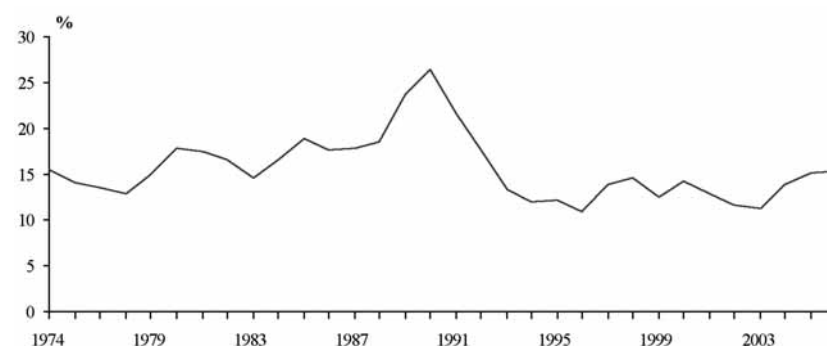
Although house prices have risen much faster than income over many years, lower levels of interest rates and the progressive narrowing of mortgage margins have meant that the cost of servicing a given level of debt has fallen considerably. The initial mortgage interest payments of new borrowers, relative to income, have risen in the past two years, but are not particularly high by historical standards, and are still considerably lower than in the late 1980s (see chart 2).

Fixed rate mortgages have become more popular, accounting for over 60% of loans taken out in 2005 and 2006, after accounting for around 30% of the market when interest rates fell away sharply in the early part of this decade.

Lenders have also competed more strongly to attract existing mortgage holders, and it has become easier for customers to switch between lenders in search of a lower interest rate. Remortgaging activity accounted for over 40% of mortgage market activity in 2004 and 2005 and around 37% in 2006, up from less than 20% ten years ago.

While both secured and unsecured debt have risen over the last decade, there has

Chart 2:
Initial mortgage interest payments as % of gross income, new home buyers

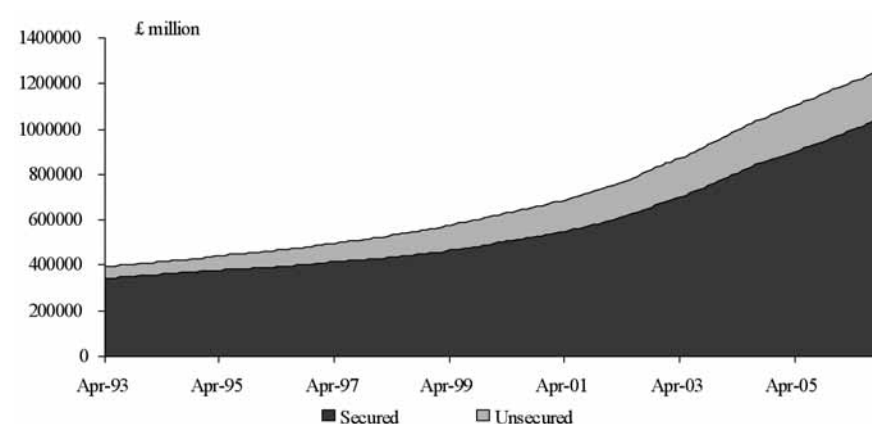


Source: Survey of Mortgage Lenders/Regulated Mortgage Survey

been a recent consolidation from unsecured to secured lending, bucking the trend seen in the preceding decade². The share of outstanding household debt held as unsecured lending rose during the 1990s. In 1993, unsecured debt accounted for 13% of all outstanding debt. This ratio rose to over 20% in the early part of this decade. However, unsecured lending now makes up less than 16% of household debt, as secured lending has risen by more than twice the rate of unsecured debt in the last

three years. As house prices have risen, increasing the amount of equity borrowers own in their homes, and as interest charged on secured lending is typically lower than that on unsecured loans, there has been a clear incentive for borrowers with a mortgage to consolidate. Government figures show that about 30% of those who borrowed against the value of their homes in 2005 did so to re-pay other debts. This amounts to around 1.5% of mortgage borrowers (see chart 3)³.

Chart 3: Outstanding household debt



Source: Bank of England

² Bank of England

³ Survey of English Housing: provisional results 2004/5 – Department for Communities and Local Government

UK HOUSING AND THE ECONOMY

Tenure patterns

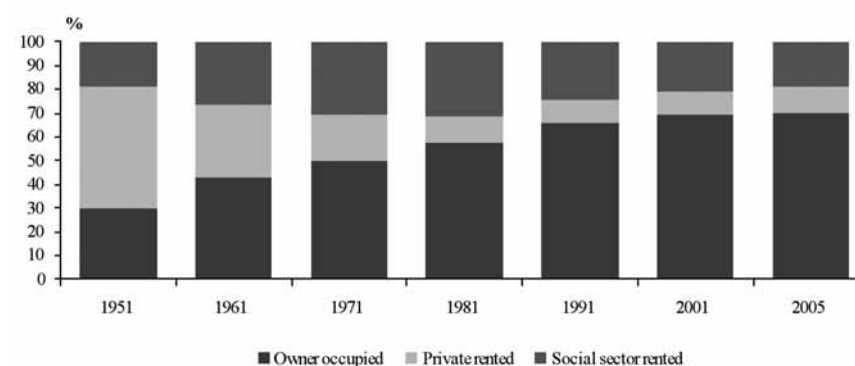
Owner occupation is the most popular choice of tenure in the UK, and has risen sharply over the last fifty years. In 1951, around 30% of households were owner occupiers, while just over 50% were in private rented accommodation and just under 20% were in public rented sector accommodation. By 2005, these shares had changed dramatically with just over 70% of properties in owner occupation. The private rented sector share fell below 10% in the early part of this decade, but had risen to almost 11% in 2005, its highest share in over twenty years.

The social rented sector saw its share of tenure rise to over 30% in the 1960s and 1970s, before steadily declining over the last thirty years to just under 20%. This decline was encouraged by the “right-to-buy” schemes introduced by the Conservative government in the 1980s, which gave local authority tenants the option to buy their homes (see chart 4).

Despite the importance of home ownership to the British population, an owner occupancy rate of 70% is not particularly high by international standards. Germany is an often cited example of a country with a far lower share of households owning their own homes at around 40%. Nations such as the United States (69%) and Australia (72%) have similar levels of home ownership to the UK, while Ireland (77%) and Spain (82%) have a considerably higher share.

An important factor that has changed the dynamics of the market in recent years is the emergence and rapid growth of the “buy to let market”. This has increased the number of properties available to rent privately. Immigration, rising student numbers and people choosing to buy their first homes later in life are all factors

Chart 4: GB household tenure



Source: Department of Communities and Local Government

boosting demand for rental accommodation. Since the introduction of buy to let mortgages ten years ago,⁵ its importance to the overall market has grown steadily, accounting for over 10% of mortgage activity in 2006⁶.

Household sector assets and liabilities

With house prices high relative to income and a significant share of the population in owner occupation, mortgage debt in the UK is higher than in a number of other

countries. The expansion of buy to let has also pushed up household mortgage debt, but not owner occupancy.

An international comparison shows that UK mortgage debt, relative to income, is much higher than in France, Germany and Japan, and considerably higher than that in the United States, despite the similar owner occupancy rate. This and the fact that most mortgages are either variable rate or fixed for short periods makes UK households more sensitive to changes in interest rate charges on mortgage liabilities (see table 1).

Table 1: Household wealth and indebtedness (% disposable income)

	Net household wealth	Non financial assets	Total liabilities	Mortgage debt
France	752.4	549.3	88.9	64.8
Germany	576.9	402.9	109.3	71.7
Japan	724.9	357.6	131.8	63.9
UK	790.3	503.9	159.0	120.3
US	573.4	279.1	135.1	101.0

Source: OECD

Notes: Data for France, UK and US are for 2005, figures for Germany and Japan are 2004. Mortgage debt for France is defined as “long-term loans”, all other countries have data specifically for mortgages. Non-financial assets are defined as consisting “mainly of dwellings and land”.

⁴ RICS European Housing Review and “Housing and Housing Finance: The view from Australia and beyond”, Reserve Bank of Australia

⁵ Buy to let mortgages in our survey are defined as “any secured loan advanced for the purpose of buying properties for residential letting purposes, whether under ARLA’s Buy to Let scheme, another approved scheme or on an ad hoc basis. It includes all loans secured on residential investment properties made to individuals or corporates where a personal guarantee is taken from the individual or the directors of that company.”

⁶ CML estimate

UK HOUSING AND THE ECONOMY

Housing has accounted for an increasing share of both sides of the UK household sector's balance sheet in recent years. House prices have moved higher relative to incomes and households have seen both mortgage debt and housing wealth rise. Residential buildings now account for over 50%⁷ of UK households' total net worth, a rise from under 40% in the late 1990s and the increase in the value of these assets accounted for nearly three quarters of the 79% increase in net worth between 1997 and 2005.

The housing market and consumer spending

The most important way in which the housing market reacts with the wider economy is through household spending, as it accounts for around 70% of economic activity.

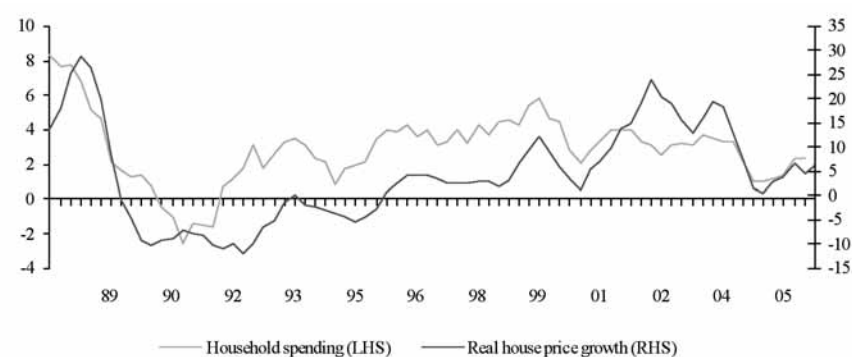
A paper by staff at the Bank of England⁸ identified three potential channels through which house prices might impact on household spending. Firstly, an increase in house prices increases wealth and consumers spend more in response. Secondly, an increase in house prices raises the collateral available to certain households and reduces credit constraints placed upon them, allowing them to borrow more. Thirdly, prices and consumption are influenced by common factors, and these factors can alter income expectations, which might drive an increase or decrease in both house prices and consumer spending at the same time rather than one leading the other. This final explanation was found to be the most significant.

The evidence is rather mixed. There appeared to be quite a close relationship between real house price growth and household spending throughout the 1980s and 1990s. But this broke down in the early part of the current decade when real house price growth rose to 20% per annum, but there was no accompanying surge in spending. There has, however, been a rather closer correlation since house price

growth slowed in 2004.

The events of the early 1990s suggests that when prices fall, household consumption is badly affected, particularly for those with uncertain employment prospects and those experiencing negative equity. There is a tendency for households to restrain their spending and reduce their mortgage debts to re-establish their solvency. And falling prices do not encourage people to enter the market, possibly because they are concerned that prices will fall further, reducing their net worth (see chart 5).

Chart 5: Real house price growth and real household spending (%)



Source: ONS, HBOS

Another recent paper by Professor David Miles⁹ came to a similar conclusion to the Bank. He calculated that a proportion of the rise in house prices in recent years reflects unrealistic expectations of continuing house price growth and, as this becomes apparent to home buyers, UK house prices are likely to fall. But he claims that the implication for household consumption is likely to be exaggerated. This is because some of the rise in house prices has been driven by factors which are peculiar to the borrowing market, rather than household consumption in general. As the important common drivers are not expected to weaken, household spending is unlikely to be badly affected.

The nature and importance of this link is important if the UK market were to

experience a fall in house prices in the future. A proportion of households would face the uncertainties associated with negative equity and many will look to restrain their consumption and reduce their mortgage debts as a priority. This is most likely to impact on recent entrants to the market, who have less equity in their homes.

A more direct link can be seen with the strength of home sales, which has long had a clear association with the strength of demand for certain types of products. Consumers are more likely to purchase durable items such as fridges, carpets, curtains and washing machines when they

move home. Income and employment in activities and professions associated with buying and selling of property, such as estate agents, conveyancing, surveyors and mortgage lending, are dependent on the level of home sales and property prices.

Although rising prices raise the household sector's wealth, they redistribute this wealth away from home buyers towards those already in the market. And this increase in wealth can only be consumed by those selling for the last time, or their beneficiaries, or those trading down. Those at the bottom of the housing ladder are burdened with higher levels of debt and debt payments in relation to income, which act to constrain their consumption.

For those already in the market and looking

⁷ 2005 Blue Book – Office for National Statistics

⁸ Bank of England Working Paper No 271 – "Consumption, house prices and expectations" – Attansio, Blow, Hamilton and Leicester. "

⁹ "UK Housing: How Did We Get Here?" – Professor David Miles, Morgan Stanley, November 2006

UK HOUSING AND THE ECONOMY

to move, rising prices also make it difficult to trade up as gaps tend to widen. However, rising prices also give households more equity in their homes against which they can borrow to consume. This equity can increasingly be accessed cheaply and earlier with increased competition between lenders in the provision of further advances, or by remortgaging and extracting equity. As it has become more difficult to trade up, many homeowners have chosen to borrow against the equity in their property to build extensions and make other improvements.

Sensitivity to monetary policy

With relatively high debt levels and a sizeable share of mortgages on variable interest rates, the UK home owning sector is more exposed to changes in monetary policy than many other countries and housing and mortgage markets have been important mechanisms for the transmission of monetary policy to the wider economy. Mortgage holders spent an average of 13.5% of their monthly outgoings on mortgages in 2005/6, up from 11.2% two years earlier. Around 60% of this was on interest payments¹⁰.

The sensitivity of the UK economy, and the housing sector in particular, was a factor when the Government assessed whether the UK should join the single European currency. It was felt that ceding monetary policy decisions to the European Central Bank would expose UK mortgage holders to unexpected changes in interest rates.

A report for the Government by Professor David Miles¹¹ in 2004 into the structure of mortgage finance concluded that a "substantial" share of households, and particularly those with high debt levels relative to income, could benefit from fixing nominal mortgage repayments for several years. However, he also found that many

borrowers attach a great deal of importance to the initial level of monthly payments (which are often discounted for the first two or three years) rather than the lifetime cost of the loan. A rapid change to long term fixed rates similar to the US market is therefore unlikely.

Despite a rise in the popularity of fixed rate mortgages in recent years, the majority of these are fixed only for the first two or three years, after which they revert to a variable rate. So although borrowers can insulate themselves against changes in short-term interest rates, and have increasingly done so, they typically only do so for short periods. UK households can experience significant changes in their disposable income after mortgage payments.

Housebuilding, planning and the Barker Review

Despite the importance of the stock of housing in overall UK wealth, housebuilding remains a relatively small part of the economy, making up under 1% of gross domestic product¹². This is quite a low share by international standards and supply has remained unresponsive to rising demand and prices.

Government figures show that growth in the number of households has exceeded the number of homes being built by a wide margin in recent years. The number of households in England is to increase by around 210,000 a year for the next twenty years, but there have been an average of just under 150,000 new homes built each year over the last fifteen years. The problem looks set to persist and is particularly acute in London and its surrounding regions, which are already densely populated. The level of house prices in London and the South East is making it increasingly difficult for people to relocate to these areas.

The UK's planning system is often cited as a key reason why supply has failed to keep pace with rising demand. Negotiations between local authorities and developers can often be lengthy and onerous and there are stringent restrictions on where new homes can be built. Reluctance to open up the countryside to development has led planning policy increasingly to encourage the building of new homes on previously developed urban land, with a push to higher density living. Consequently, the share on new homes built as flats has risen from around 20% in 2000 to almost half in 2006 with a corresponding drop in the share larger of detached homes¹³.

In an attempt to understand the supply side problems with a view to reform, the Government commissioned the Barker Review of Housing Supply¹⁴. The recommendations were published in 2004. The report estimated that the private sector needs to build at least 50% more homes each year compared to the 2002/3 level if the long term rate of real house price growth is to be reduced to 1.8%, compared to around 8% over the last decade.

A second review by Ms Barker¹⁵ looking specifically at the planning system recommended that it should be streamlined. It recommend that planning bodies review their policies on green belt land (where development is often prohibited) and take a more positive approach to developments that might enhance the quality of this land. There is no sign yet of the Government reaching its target to build 200,000 new each year in England. Meanwhile estimates of household growth have increased above target, making the level of building inadequate to meet the objective of slowing real house price growth.

¹⁰ "Family Spending: 2006 edition" – Office for National Statistics

¹¹ "The UK Mortgage Market: Taking a Longer –Term View", published March 2004 and authored by Professor David Miles

¹² Estimates calculated from: DTI estimate that the building of private and public sector housing accounts for 16.5% of construction each year and ONS estimates that construction accounts for 6.1% of Gross Domestic Product.

¹³ Figures from NHBC

¹⁴ "Barker Review of Housing Supply", published March 2004 and authored by Kate Barker, a member of the Bank of England's Monetary Policy Committee.

¹⁵ "Barker Review of Land Use Planning", December 2006

UK HOUSING AND THE ECONOMY

Government interaction with the housing market

Housing has risen up the political agenda in recent years. The Government is keen to promote home ownership and has expressed an aspiration to see 75% of the population owning their own homes. This comes against a backdrop of increasing difficulties for many people in getting on the housing ladder, particularly those in a number of strategically important public sector professions such as nurses, firemen and police.

There has been a marked change of emphasis towards low cost ownership, with a variety of initiatives aimed at helping people onto the housing ladder. Although the scope of these projects remains small compared to the market as a whole, schemes have been introduced where people can buy a share in their homes, with landlords, the Government or lenders also holding a stake.

This focus on low cost home ownership is a marked shift away from earlier housing market policies. In the past, home ownership has switched from receiving a substantial net subsidy from public funds to a substantial contributor of revenues. Tax relief on mortgage interest payments was phased out during the 1990s, while stamp duty (a transaction tax on buying a property) rates have risen and higher house prices have made a far larger share of sales liable for the tax. The Government's revenue from inheritance tax related to the sale of property on death has also increased as the threshold has failed to rise in line with house prices¹⁶.

Prospects

The current conditions do not seem to be in place for a major housing market "correction". The outlook for income and employment growth is positive, the cost of financing mortgage debt is still low and supply will continue to lag behind demand. All these point to prices continuing to rise ahead of earnings for the foreseeable future. This means that the equity of those who already own their own homes will continue to grow, providing them with collateral against which to borrow for consumption or investment purposes. But the impact of this is likely to be diluted by the fact that higher prices will reduce affordability and make moving house become more difficult. This is likely to reduce the number of home sales over the next couple of years, with knock on effects to housing related purchases and the incomes of those in the house buying and selling process.

Although owner occupation is clearly the preferred tenure in the UK, and the Government is keen for it to grow, the buy to let sector is likely to continue to expand the coming years, partly as a response to changing tenure preferences amongst young adults, but also a growing number of single person households and migrants.

¹⁶ Various Budget reports from HM Treasury

THE IRISH HOUSING MARKET

The Irish Housing Market

By Jim Power¹

INTRODUCTION

The Irish housing market has experienced rapid growth over the past decade, both in terms of residential housing construction and residential property prices. The dramatic performance of the market has attracted considerable domestic and international interest and comment. Some view the recent market performance as a bubble that will inevitably burst, while others argue that the development of the market has been firmly underpinned by the underlying performance of the economy and Ireland's unique demographic characteristics.

This article examines the recent performance of the housing market, the factors that have driven the performance of the market and it seeks to throw some light on where the market might go in the future.

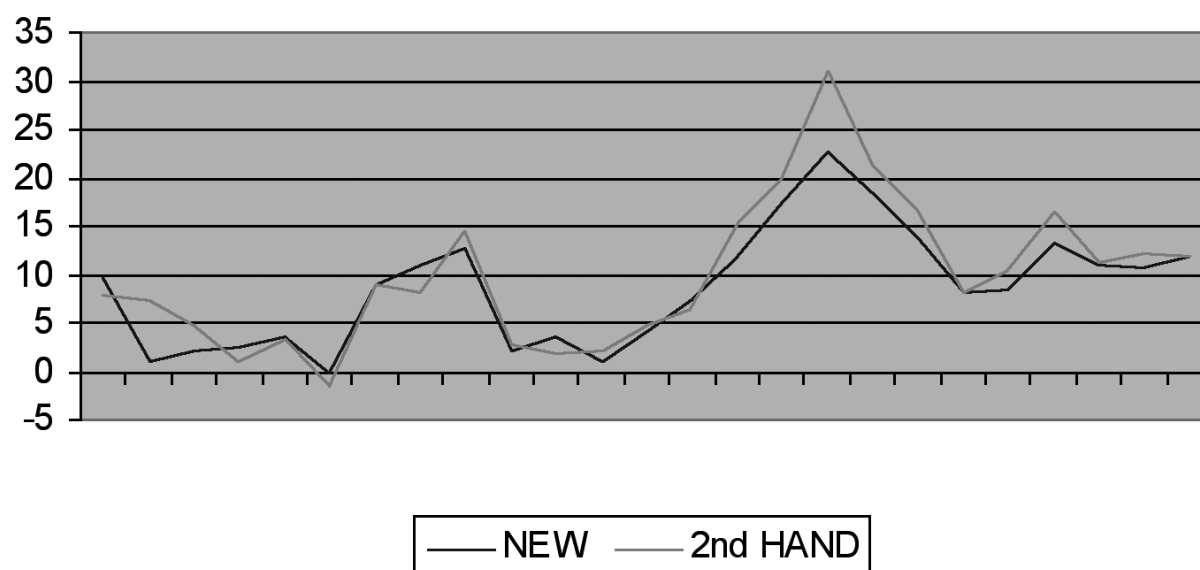
HOUSING MARKET BACKGROUND

The residential housing market in Ireland has been characterised by very buoyant levels of activity in recent years. House prices, housing completions and the mortgage market have all grown exponentially.

Between 1996 and 2006 new house prices increased by a factor of 2.5 and second hand prices increased by a factor of 3.3. Over that period new house prices have recorded annual average growth of 13.6%, and second hand prices have recorded annual average growth of 15.9% (Chart 1).

Chart 1

House Price Growth (YoY)



SOURCE: Department of Finance, Dublin.

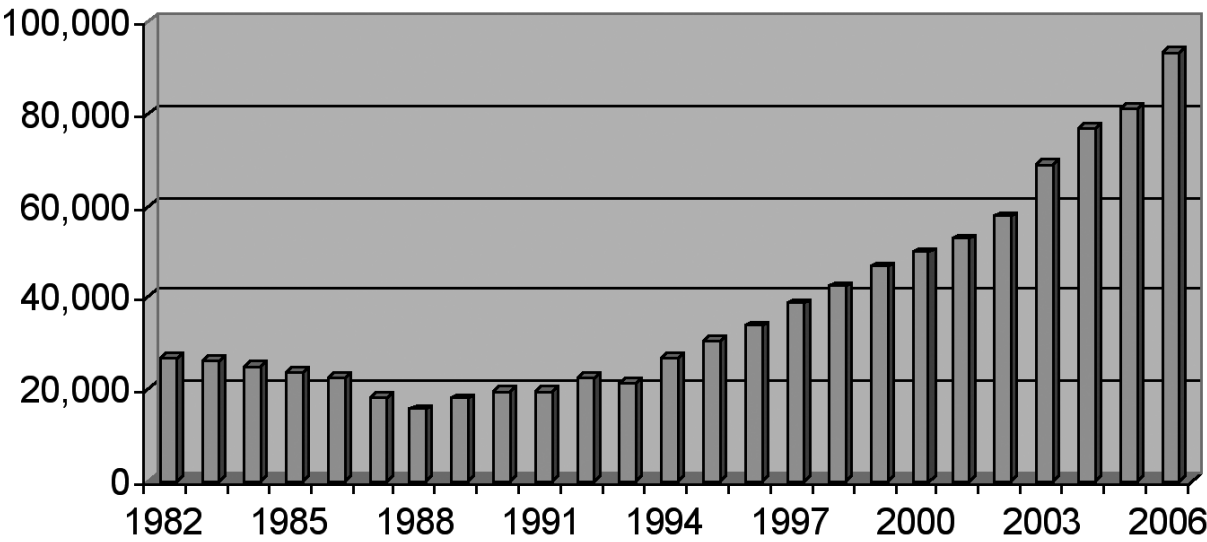
⁴ Jim Power is Chief Economist at Friends First, a financial services group in Dublin

THE IRISH HOUSING MARKET

Housing construction has also expanded rapidly. In the 10-year period to 2006, 608,000 residential units were built, with almost 80% of those completed since 2000 (Chart 2).

Chart 2

RESIDENTIAL UNIT COMPLETIONS



SOURCE: Department of the Environment, Ireland.

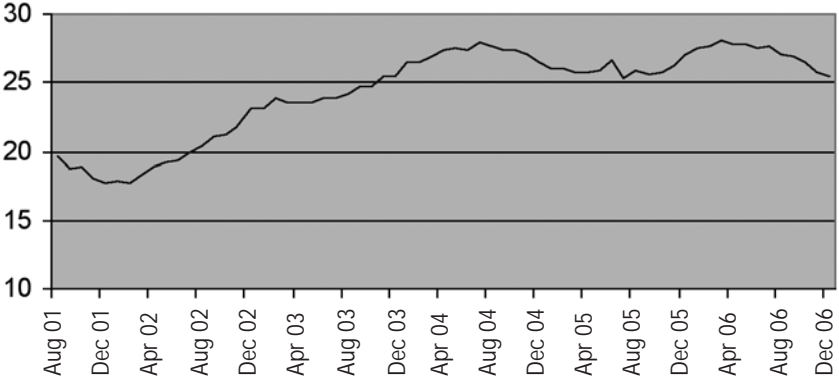
In line with this strong growth in house prices and completions, the residential mortgage market has also expanded very rapidly. Between December 2000 and December 2006 the level of residential mortgage credit outstanding increased from €29.5 billion to €110.6 billion. In order to capture the mortgage indebtedness of Irish residents more accurately, the level of

outstanding securitised mortgages needs to be added back. This adjusted measure, which is a better reflection of the true indebtedness situation, shows that total mortgage lending outstanding has increased from €32.5 billion in December 2000 to €123.3 billion in December 2006. As a percentage of GDP mortgage credit has grown from 31% in 2000 to 69% in 2006.

The annual growth rate in mortgage lending peaked at 28.1% in the first quarter of 2006. It has subsequently eased back, but still stood at a strong 25.5% at the end of 2006 (Chart 3).

Chart 3

Growth in Mortgage Credit (YoY)



SOURCE: Central Bank of Ireland

THE IRISH HOUSING MARKET

THE DRIVING FORCES

The evolution of the Irish housing market over the past decade did not just happen by accident, but was due to a number of fundamental factors that can easily explain the market performance.

These include:

- Strong economic growth.
- A collapse in unemployment.
- The lower interest rate environment that followed entry to the European Monetary Union (EMU) in 1999.
- The increased availability of mortgage credit as a result of the ongoing deregulation of the financial services market.
- The growth in population.
- The age profile of the population.

- The average household size in Ireland is steadily declining.
- Official policy towards housing.
- Ireland still has a relatively low housing stock level compared with the rest of Western Europe. There are less than 400 dwellings per thousand of the population in Ireland, compared to a Western European average of 475.

THE ECONOMIC TRANSFORMATION

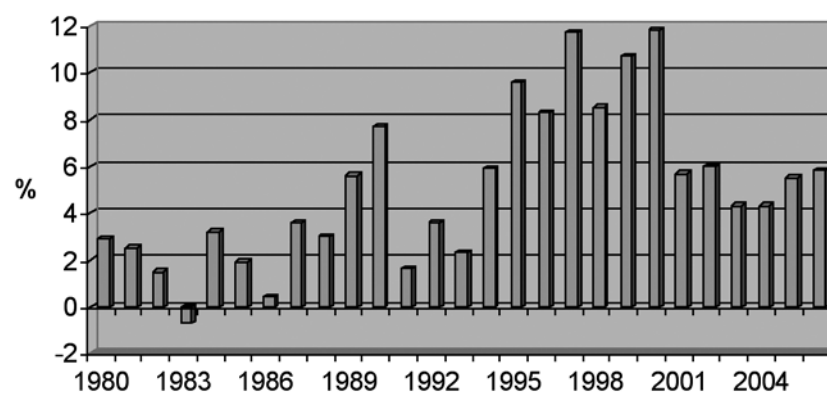
In seeking to understand where Ireland is today and more importantly where it might go in the future it is essential to understand the factors that gave rise to the economic transformation. An important point to make is that the transformation of the economy

was not the result of a lucky accident or any single policy initiative, but rather was due to a combination of factors, some fortuitous and some deliberate. All of these factors coincided to push the economy on to a higher growth platform.

Over the past fifteen years the Irish economy has been transformed from a country of sluggish economic growth (Chart 4), high unemployment (Chart 5) and serious fiscal imbalances (Chart 6), into an economy which today has the lowest unemployment rate and one of the strongest fiscal situations in the European Union. It also now has a record number of people in employment (Chart 7)

Chart 4

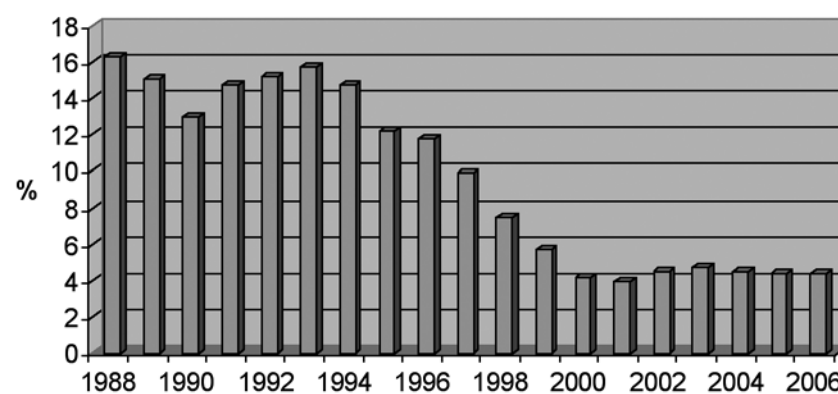
GDP Growth



SOURCE: Central Statistics Office, Ireland

Unemployment Rate

Chart 5



SOURCE: Central Statistics Office, Ireland

THE IRISH HOUSING MARKET

Chart 6

Government Debt (% GDP)

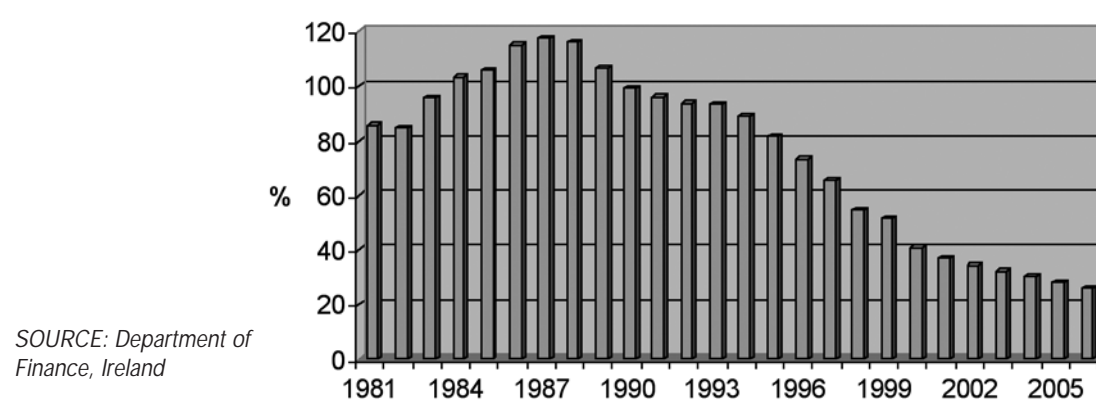
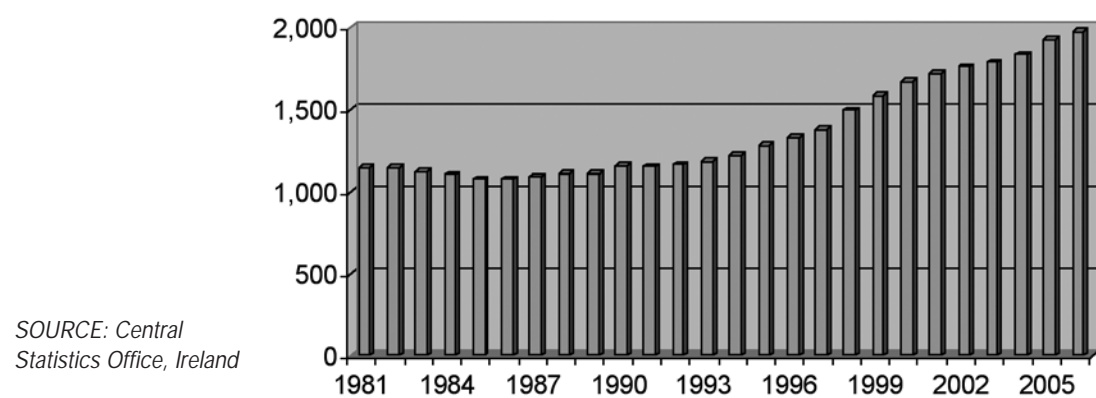


Chart 7

Total Employment (000s)



THE IRISH HOUSING MARKET

The most important contributory factors have been:

1. MEMBERSHIP OF THE EUROPEAN UNION (EU)

Membership of the EU and the deepening of that membership have fundamentally changed the nature of the Irish economy, both in terms of allowing trade

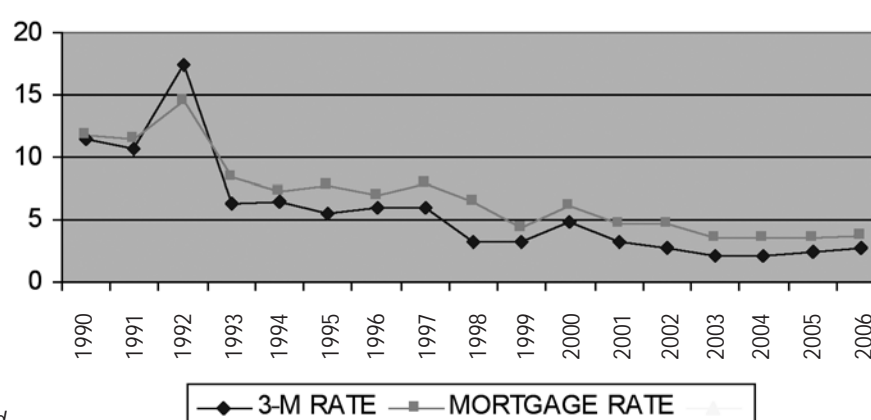
diversification away from the previously dominant UK market, and the funding received from the EU to improve the structures of the Irish economy. At their peak in 1991, net receipts from the EU were equivalent to 6.2% of GDP.

Ireland was a founding member of the Single European Currency in 1999 and this delivered a historically low level of interest

rates, which gave a significant boost to economic activity. In 1990 the three-month inter bank interest rate in Ireland stood at 11.5%. By the end of 2006 it stood at just 3.7%. The average mortgage rate fell from 11.5% to 3.5% over the same period (Chart 8).

Chart 8

Interest Rates



SOURCE: Central Statistics Office, Ireland

2. FOREIGN DIRECT INVESTMENT

Ireland has achieved considerable success in attracting foreign direct investment (FDI), particularly from the US in activities such as financial services, the IT industry, and the Chemical & Pharmaceutical industry. The success in attracting Foreign Direct Investment (FDI) from the United States has been primarily due to the low corporation tax rate regime, the availability of a young highly educated and English speaking labour force, and Ireland's geographical market position within the EU.

3. OFFICIAL POLICIES

Sound fiscal management since 1987 has seen the Exchequer borrowing requirement fall from 11.4% of Gross National Product (GNP) in 1986 to a deficit of just 0.1% of

GNP in 2006. This improvement in the fiscal situation has facilitated a steady easing of the personal tax burden in the economy, a move that has encouraged effort, initiative, and labour force participation.

The Social Partnership model, which has been in existence since 1987, has contributed to a more stable and certain wage environment for employers. In return for this greater certainty, the Government has gradually eased the direct personal tax burden.

Ireland has traditionally had a very strong culture of home ownership, and more recently, the trend has been towards second or third homes for investment or holiday purposes. Official policy supports this culture, through mortgage interest relief for owner occupied and investment homes.

Furthermore, generous incentives have been in place over the past decade to encourage housing development in some regions of the country. These incentives are now being phased out.

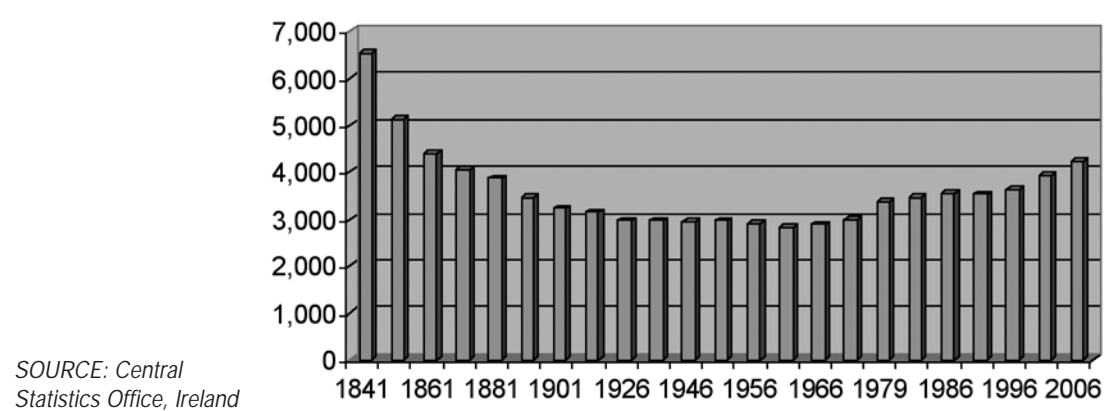
4. DEMOGRAPHIC CHANGE

The demographic profile of the population has made a major contribution to Ireland's potential growth rate. The population of Ireland declined steadily between 1841 and 1961. It has subsequently recovered strongly and reached 4.23 million in 2006, which is the highest population since 1861 (Chart 9).

THE IRISH HOUSING MARKET

Chart 9

Population (000s)



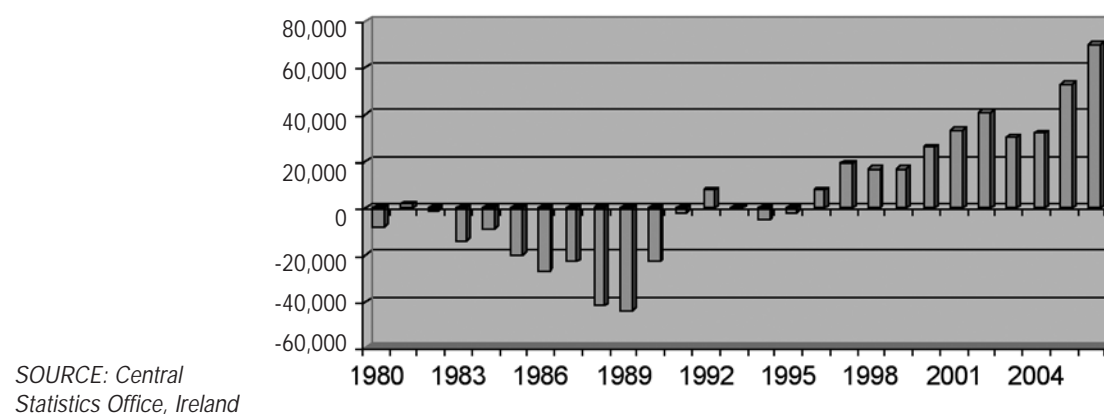
The number of births in Ireland grew strongly during the 1970s and peaked at 74,000 in 1980. This 'baby boom' resulted in strong growth in the supply of young people in the 1990s and the resultant growth in the labour force added significantly to the supply side potential of the economy during that decade and proved attractive to companies in the US and Europe who faced labour shortages in their own markets. Thanks to the introduction of free second level education in 1967, the nature of the

labour supply was of a very good quality. Moreover, a further increase in quality resulted from the introduction of free third level education in 1995. However, population growth can in some circumstances simply result in higher emigration and/or higher unemployment, as was the case in Ireland in the 1980s. The economic conditions need to be put in place to create the jobs that will exploit the potential labour supply. This is what happened in the 1990s.

A turn around in migration flows has been an important driver of population growth over the past decade. Between 2000 and 2006 there was total net inward migration of 285,000, which compares to total net inward migration of 37,000 between 1990 and 1999 (Chart 10).

Chart 10

Net Migration



THE IRISH HOUSING MARKET

5. AGE PROFILE

As well as a growing population, Ireland has a very young population. Out of a population of 4.1 million in 2005, 1.02 million or 24% were in the 20 to 34 year age cohort, and 52% of the population was under the age of 35 years. This bulge in the population in the household formation age

segment of the population is ensuring ongoing strong demand for housing.

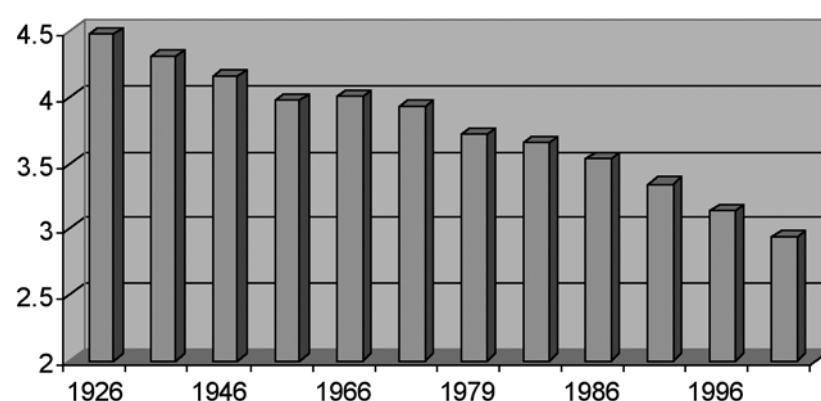
6. HOUSEHOLD SIZE

The average household size in Ireland has been declining steadily over the past century. In 1926 the average Irish household had 4.48 people, and this had fallen to 2.94

by 2002 (Chart 11). The legalisation of divorce in the 1990s has contributed to this fall in household size and the trend is set to continue. With a growing population and falling household size, it implies increased demand for housing in a country where the home ownership rate stands at an internationally high level of 77%.

Chart 11

Average Size of Household



SOURCE: Central Statistics Office, Ireland

The net result of all of these factors is that the Irish economy moved on to a higher growth plane in the 1990s, particularly in the second half of the decade. Between 1991 and 2000, GDP growth averaged 7.4% per annum, and actually averaged 10.2% per annum between 1996 and 2000. It is important to recognize that the 1990s should be seen as a catch up period for the Irish economy. It effectively moved from a seriously under developed economy to a more modern developed economy. The sort of growth rates that Ireland has enjoyed typically characterize a catching up process of this nature, but the important point is that once the catch up phase is complete, economic growth will inevitably slow of its own volition.

The potential growth rate of an economy is the level of economic activity that an economy can expect to achieve if all resources are fully utilized. It is primarily determined by growth in employment and productivity. In the second half of the 1990s, growth in employment averaged over 5%

per annum and growth in productivity is estimated at around 3% in real terms. In an Irish context productivity is difficult to measure because of the transfer pricing activities of multi-nationals, which distort measurement. However, on a conservative estimate of 3%, it would suggest that the potential growth rate of the economy in the second half of the 1990s was around 8%. Economies of course do not necessarily always realize their potential, but in Ireland this turned out to be the case due to a combination of good luck and sound economic policies.

The potential growth rate of the Irish economy in the 1990s was driven higher by solid productivity growth and strong inflows into the labour market. Employment growth averaged 3.7% per annum during the 1990s, but averaged a very impressive 5.5% per annum in the second half of the decade. The flows into the labour force were driven by the sharp decline in unemployment, higher labour force participation rates for both males and

females, and steady inward migration. The unemployment rate declined from 15% of the labour force in 1989 to 4.3% in 2000. Over the same period total employment in the economy expanded from 1.111 million people to 1.67 million. Between 1990 and 1995 there was net outward migration of 24,000, but between 1996 and 2000 there was net inward migration of 87,000.

Following the frenetic levels of economic growth during the 1990s, it was always inevitable that growth would slow somewhat after 2000 and this is indeed what has transpired. GDP growth averaged 5.2% between 2000 and 2005; a strong performance by any international standard, but still an easing from the levels seen over the preceding five years. Against this growth background, the unemployment rate has remained around 4.4% of the labour force and employment expanded to a record high of 2.07 million in the third quarter of 2006.

This economic transformation in a relatively short period of time generated very strong

THE IRISH HOUSING MARKET

demand for housing and pushed activity levels in the housing market up sharply. However, apart from these economic factors, there are also a number of structural factors that also help explain the unprecedented evolution of the housing market.

CONCLUSIONS

All of the aforementioned factors have combined over the past decade to generate very strong demand for housing, and the market has responded with strong supply. It is clear from most recent data sources that the Irish housing market still remains strong in absolute terms, but the market is gradually slowing down, both in terms of the number of loans, the value of those loans, house prices and housing completions. In an environment of rising interest rates this slowing trend in growth rates is to be welcomed.

There is still nothing in the overall data to suggest that the market is starting to experience a hard landing, and indeed the gradual slowdown that is occurring in the overall market is to be welcomed and does suggest a stronger degree of sustainability in the longer-term. In 2007, house completions are likely to ease back towards 85,000 units, while national average house prices are likely to increase by around 5%, less than half the rate of house price inflation seen in 2006.

There is still quite a degree of skepticism abounding about the possibility of such a 'soft landing'. However, the reality is that the fundamental demand in the market place is still strong and is not about to disappear. Net inward migration in 2007 is likely to be around 70,000, and there are still over 1 million people in the 25 to 34 year old age cohort. Apart from these demographic features, there are also a number of structural features of the market that should ensure that demand will remain strong. Average household size is still declining. Social change is also important, with the legalization of divorce leading to household breakup and greater demand for housing. There is also continued strong demand from investors to satisfy the rental market.

All of the aforementioned factors are still driving strong demand and are unlikely to disappear. On the other hand there has been a very strong supply side response, but the headline number of housing completions distorts the supply situation somewhat. The reality is that due to tax incentives some of the supply is coming on stream in areas where there is little demand from owner-occupiers, and many of the homes are ending up idle or occupied for short periods of the year.

The reality is that the death of the Irish housing market is grossly exaggerated and while 2006 should represent the peak of the housing cycle in terms of price inflation and completions, the market looks set to remain solidly based. Beyond 2007, house price inflation should settle down to levels broadly consistent with general inflation out to the end of the decade.

While the Irish housing market has experienced dramatic growth over the past decade, its evolution has been driven by easily understood fundamental forces and structural characteristics of the market. Consequently, it does not fit the classic definition of a bubble, but an easing of activity would now be very desirable.

THE SPANISH HOUSING MARKET

The Spanish Housing Market

by David Nogales, Deputy Director Fixed Income,
Gonzalo del Real (Director Risk Analysis) and
Jesús Portomarín (Risk Analysis) – Ahorro Corporación Financiera

The Housing Market and the Spanish Economy

In the past few years housing prices in Spain have experienced notable growth, although this trend has been less marked in the last few months. Undoubtedly, we believe that this behaviour responds to a tendency towards equivalence with other

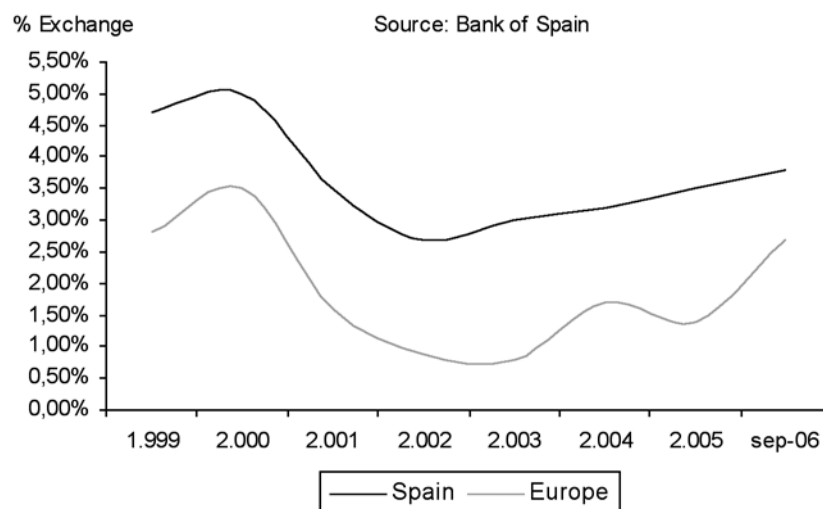
countries of similar size and economic development, and which, once similar levels in housing prices to such countries have been achieved, shall stabilise, in what is generally termed a soft landing.

A series of factors have been present in this period which has influenced to a greater or lesser extent such major increases in

housing prices: strong macroeconomic growth, unemployment reduction, reduction of interest rates, immigration, a home ownership society...

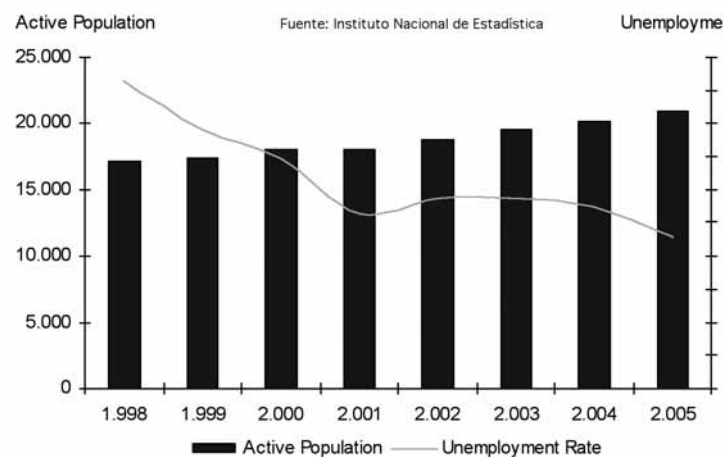
- Strong macroeconomic growth: Spain has enjoyed a series of boom years which have resulted in GNP growth above the EU average (see chart below).

Spain's Gross National Product Evolution



- Unemployment reduction: a significant indicator of this boom climate has been the reduction of the unemployment rate, which has become lower than 10%, in its turn accompanied by an increase in the active population (see chart alongside)

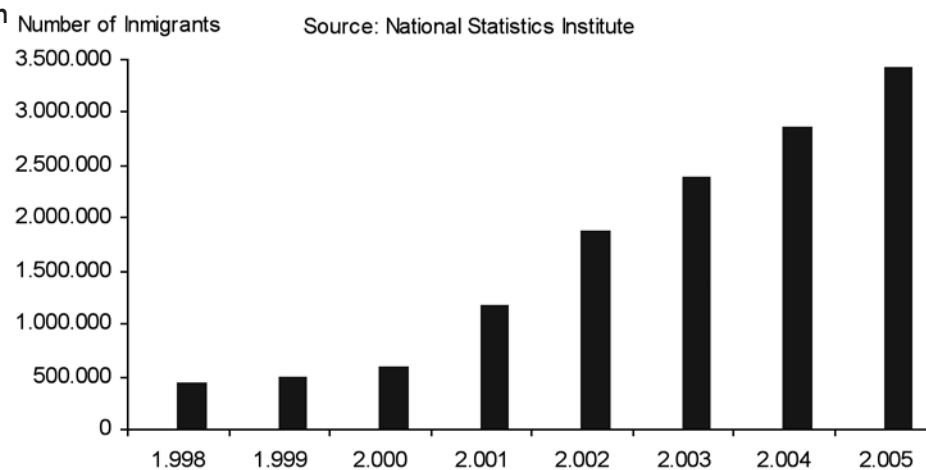
Unemployment rate compared with active population (in thousand)



THE SPANISH HOUSING MARKET

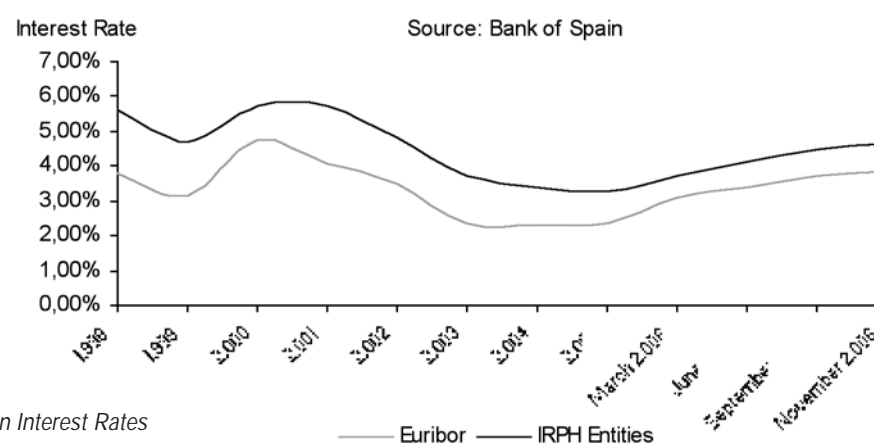
- Household creation impulse:
- 1. Important growth of the potential first household demand population (20 to 35 years old).
- 2. Decrease in households' average size, that in recent years has gone from 3.57 back in the 80's to 2.86 in 2001, while the European average is 2.5). To achieve European's household sizes in the following 10 years will result a household demand of around 2 millions (200,000 houses a year).
- 3. Strong foreign resident population, with a result of a growing percentage of household demand.

Immigrants Population Growth



- Reduction of interest rates: which, together with the fact that Spain is a homeowners' society, has contributed to the fact that mortgage "Debt to Income" has remained at affordable levels (See interest rates Evolution in Chart below).

Interest Rates Evolution



IRPH: Average Mortgages Loan Interest Rates

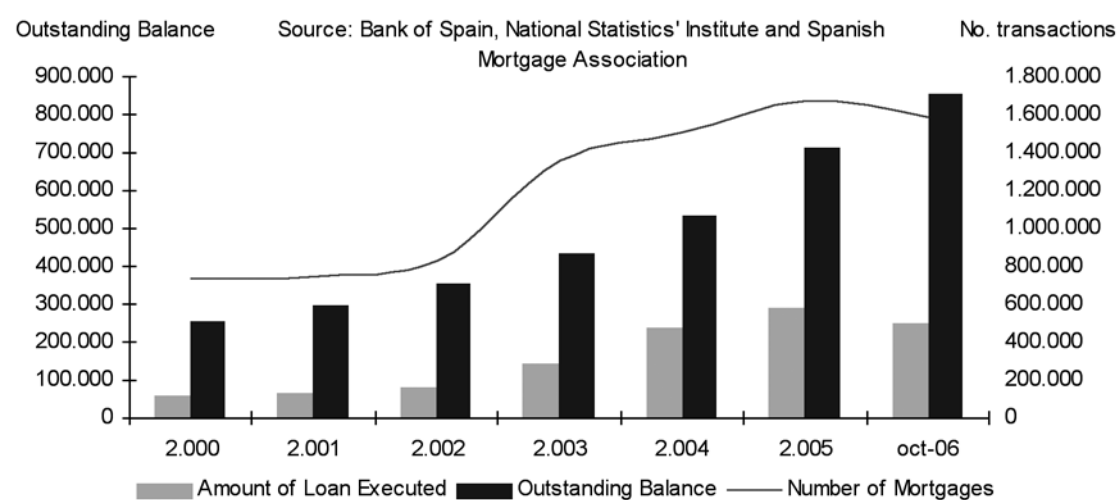
THE SPANISH HOUSING MARKET

- Homeowners' society: Spaniards have always been culturally conditioned in favour of home ownership, as opposed to renting. To a certain extent this is increased by:

1. Tax incentives for the purchase of homes; deduction of a percentage of mortgage payments in income tax statements.
2. Legal obstacles to renting: difficulty of evicting a tenant in arrears, duration of leases.

Undoubtedly all the aforementioned factors have resulted in significant growth in the number and amount of outstanding mortgages in the past decade (See chart below, data in million Euro):

Outstanding Mortgages (Number and Balance) – Executed Loans

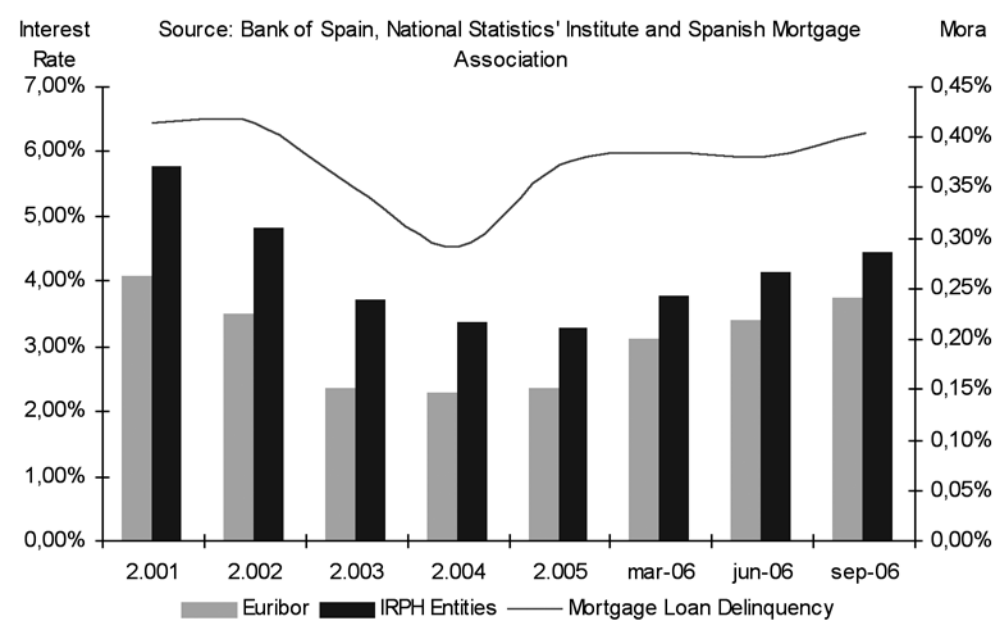


In spite of the major increase in the number of mortgages and the outstanding balance thereof, the default percentage has remained at a historical low, although in the

past few months there has been an upsurge in delinquency levels. Such low delinquency levels have been influenced by the importance of the home as an asset in the

minds of Spaniards with the result that the mortgage is the last thing they will want to stop paying.

Interest Rates Evolution and Delinquency



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Additionally, each household's ability to deal with its mortgage debt has been increased by: women's access to the labour market, the strong competition between financial institutions which has resulted in more favourable loans, plus a greater sophistication of mortgage products offered by financial institutions and protection measures for mortgage holders promoted by the Government and the Bank of Spain. From the opposite standpoint, the current interest rate increases will hinder payment of mortgages in certain cases, all the more in the case of recent mortgages, granted at lower rates, with significant outstanding amounts and less incentive to pay, because a considerable amount is still left to pay and that their mortgage has been outstanding only under low interest rates. The Bank of Spain's concerns about the evolution of the mortgage market has been constant and has tended to the increase and supervision

of the provisions to be allocated by financial institutions for the loans granted thereby, so that the system may be a significantly protected by a close monitoring of the information to be forwarded by such institutions to the Bank of Spain.

Financial Institutions

The main players in the evolution in housing prices and the Spanish mortgage market have been the institutions which form part of the Spanish financial system:

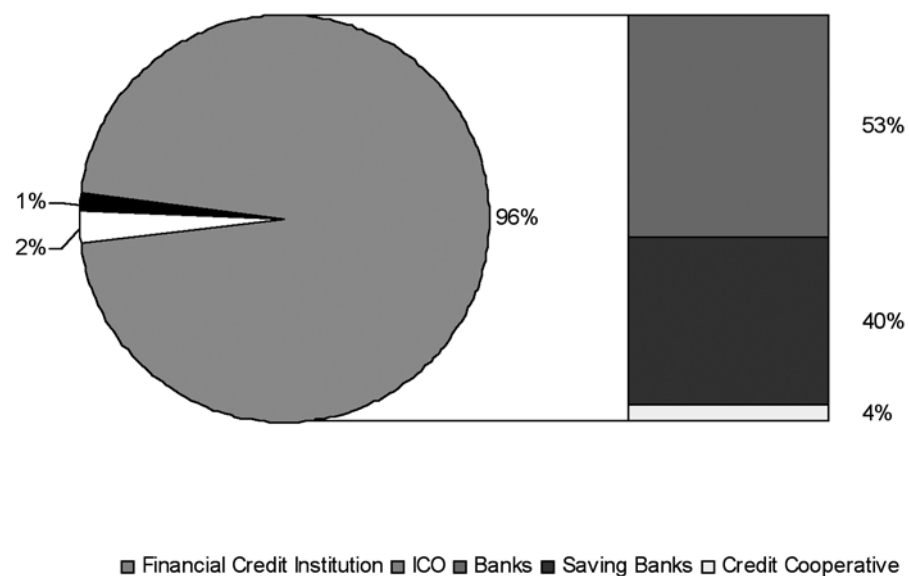
In September 2006, the Spanish financial system consisted of a total of 351 institutions with a total consolidated balance sheet amount of 2,430,863 million Euro. As of the end 2000, there were 368 entities with a total balance sheet amount of 1,133,355 million Euro, showing that approximately in the past six years the Spanish financial system has grown in

business volume (+114.5%) and has experienced a process of consolidation.

This consolidation process has been carried out mainly by Spanish Banks, which went from 110 in 1993 to the current 73, which entities in their turn form part of large financial groups. In the same period, the number of Savings Banks has decreased from 52 to 47 and Credit Co-operative Institutions (Cooperativas de Crédito), whose number was initially 100, are now 83. Such decreases have been offset in part by a greater presence of foreign institutions, through Foreign Branches, 53 in 1993 and currently 70.

The following chart sets forth the distribution of the total balance sheet amount by types of institutions as of October 2006:

Spanish Financial Institutions – Balance Sheet Amount



THE SPANISH HOUSING MARKET

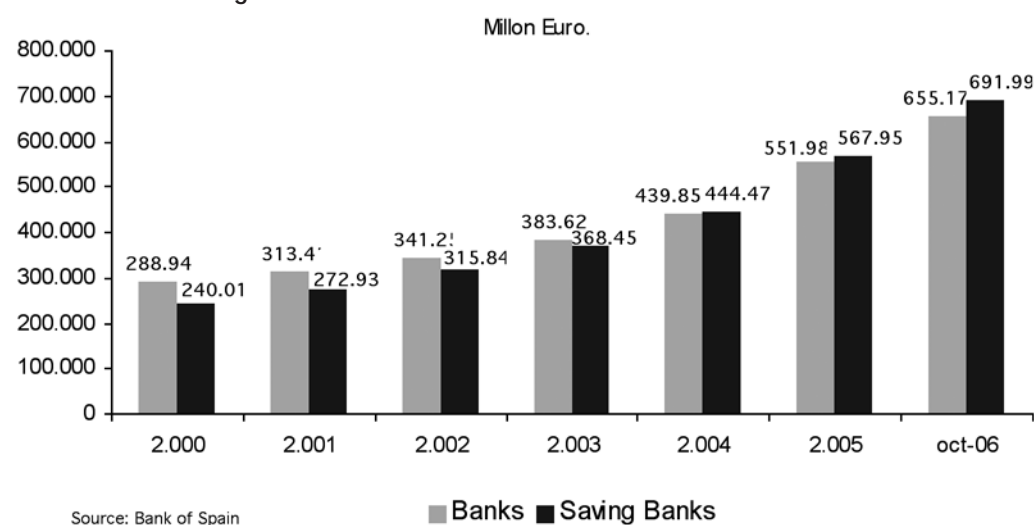
As observed above, the bulk of financial business is conducted by Banks, Savings Banks and Credit Co-operative Institutions. In the Spanish financial market, the credit business, including services rendered to the Public Administrations, according to data published by the Bank of Spain, reached

1,482,906 million Euro as of end October 2006, a 151% growth compared to end 2000 (590,800 million Euro).

As of end October 2006, Banks and Savings Banks jointly held a market share of 91% in the Credit Business. Currently Savings Banks are the leaders in the credit business,

although in 2000 this activity was controlled by Banks, as reflected in the following chart, which also shows an increase in the credit portfolio managed by Savings Banks and Banks (Total Portfolio = Savings Banks' Portfolio + Banks' Portfolio)

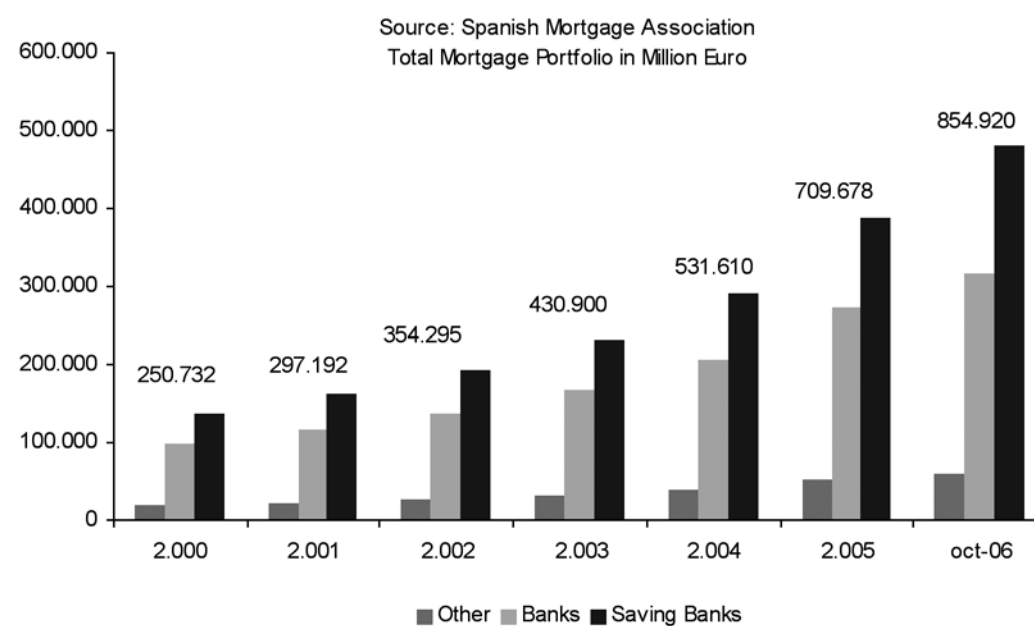
Total Portfolio : Banks and Savings Banks



The evolution in the Total Amount of the Outstanding Balance of the Mortgage

Credit Portfolio, in million Euro, by type of institution, is reflected in the following chart:

Mortgage Portfolio : Banks and Savings Banks



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Cédulas Hipotecarias

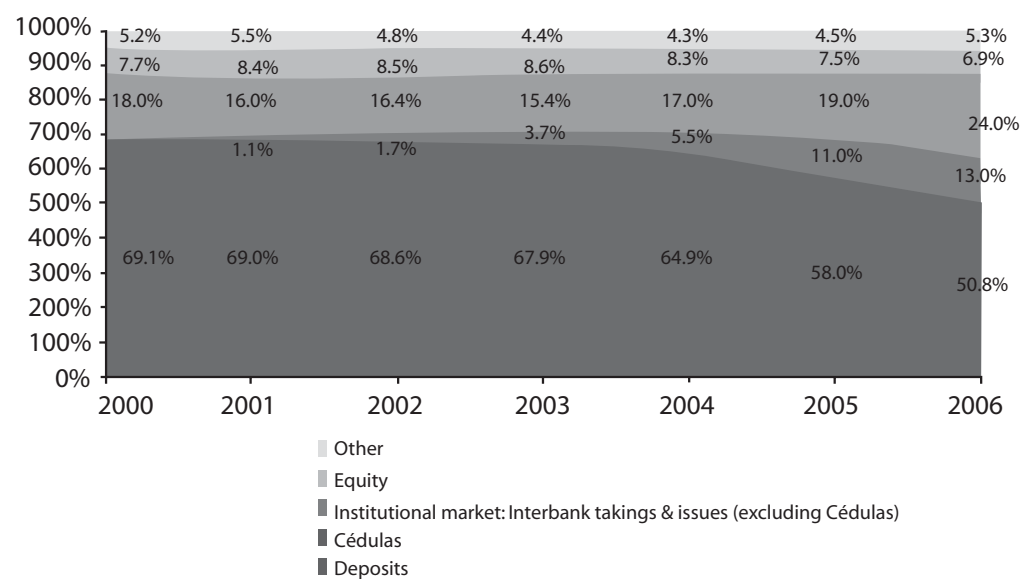
Such growth in the mortgage portfolio at more than 20% per year, and following a steeper curve since 2003, has been accompanied by a reduction in client deposits, traditionally financial institutions'

main source of financing.

Cédulas have been a key funding instrument for financial institutions and have contributed to maintain the mortgage lending capacity that we have just seen. Savings Banks' funding structure has

always had deposits as its main source but, since 2001 due to low interest rates, the percentages of them within the funding structure has been reduced and this gap has been filled in, mainly, by Cédulas.

Savings Banks' Funding Structure

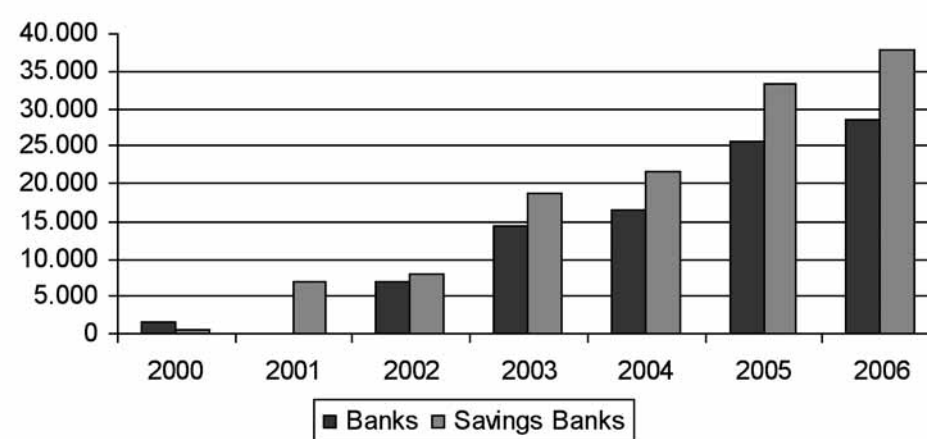


The reduction of deposits in the liabilities' side of the balance sheet of financial institutions and Savings Banks in particular,

as a result of the aforementioned economic boom and the clients' search for other kinds of investment, has been accompanied by an

increase in the volume of Cédulas Hipotecarias.

Issues of Cédulas: Banks and Savings Banks



THE SPANISH HOUSING MARKET

Cédulas Hipotecarias are Covered Bonds established by law under the Mortgage Market Law (Ley del Mercado Hipotecario) of 1981 March. The main difference between Cédulas Hipotecarias and other Covered Bonds is that Cédulas hold a privileged guarantee over the total mortgage portfolio of the issuer, while other covered bonds have a limited pool of assets backing the issue. Due to strict Spanish legislation, Cédulas constitute the assets backed by a very high coverage of collateral which is considered one of the highest in the covered bond world. The minimum legal overcollateralisation for Cédulas is 111%, and the average over-collateralisation of the cédulas' market is over 250%. Taking this level into account, in order to lose money in any cédula, more than half of the mortgages would have to default and the value of those properties must be zero,

which would be something similar to Spain disappearing from the map. Additionally, under the current Spanish Insolvency Law, Cédulas are closer to a bankruptcy remote structure similar to other Covered Bonds.

The law makes sure that there is not only more collateral available than cédulas issued, but also that such collateral has good credit quality. The law limits the amount of an issue of cédulas to a percentage of the so-called "eligible asset portfolio", but the whole mortgage portfolio, eligible or not, constitutes the backing of outstanding cédulas at any time; the issue limit is set at 90% of the eligible portfolio.

The main conditions to be met by eligible mortgage loans are:

-Maximum Loan to Value (LTV) ratio of 80% for residential properties and 70% for

commercial properties.

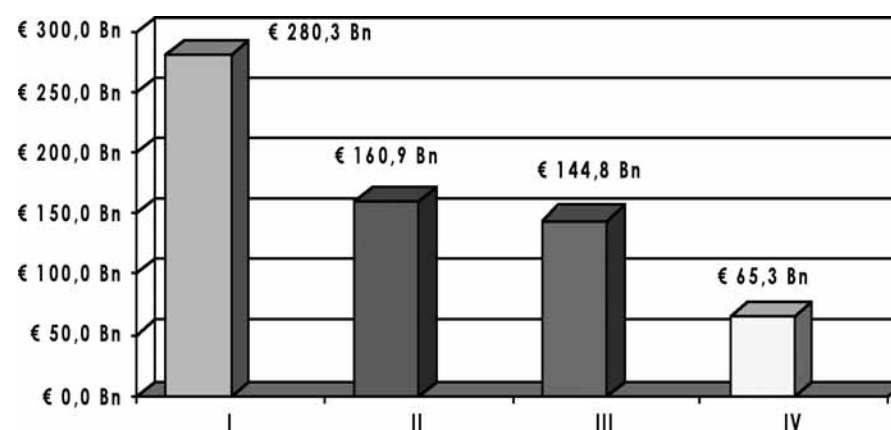
-Only first mortgages are eligible and have to be duly registered in a Spanish Property Registry.

-The value of the property has to be assessed by an independent appraisal company, which must have been authorised and subject to supervision by the Bank of Spain.

-The property must be insured for its total value.

This is shown in the next chart, where the Total Mortgage Portfolio is represented by the 1st column box (€280.3 bn) (I), the remaining portfolio backing the cédulas issued (4th column, €65.3 bn (IV)), which represents an overcollateralisation of 429,1%. In its turn, the eligible portfolio, (2nd column, €160,9 bn (II)) sets the legal issue limit (90%) thereof (3rd column).

Cédulas Structure



The above is a current example of the OC level and issue limit of "AyT Cédulas Cajas", the Covered Bond funding tool for the 43 savings banks which are shareholders of Ahorro Corporación.

Back in 2001, Ahorro Corporación Financiera designed the initial "AYT Cédulas Cajas" transaction whereby AAA/Aaa/AAA rated bonds were issued, backed by Cédulas Hipotecarias issued by Spanish Savings Banks. Throughout these years, the concept has been developed, adding extra value to the initial issue.

On December 2005, ACF created "AyT

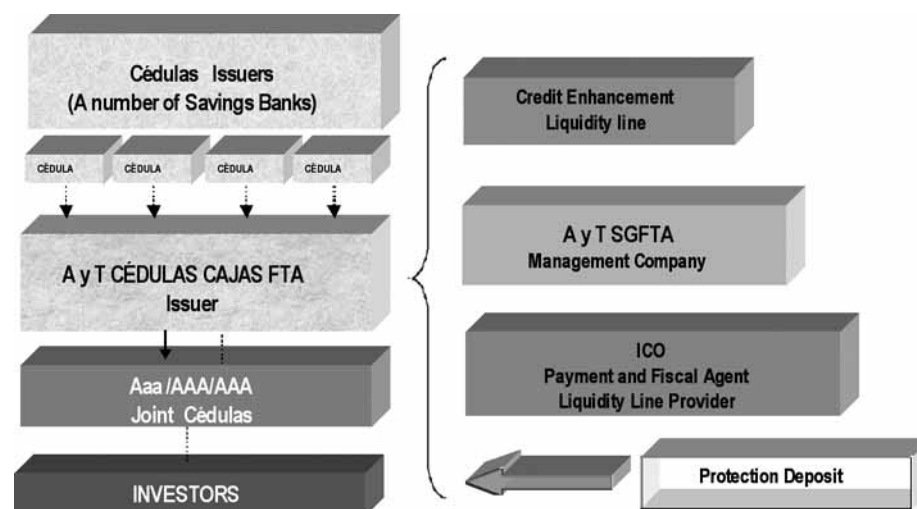
Cédulas Cajas Global, Fondo de Titulización de Activos", a Funding Programme using Cédulas currently managed by Ahorro Corporación for its shareholders. The programme purports to issue fixed or floating rate notes backed by fixed or floating rate Cédulas, issued by up to 43 different Spanish savings banks or cajas specifically for the programme.

Structure

The issuer, AyT Cédulas Cajas Global, is a securitization fund regulated by the Comisión Nacional del Mercado de Valores, the Spanish Securities' Commission

(CNMV). The fund has been set up in accordance with Law 19/1992 and Royal Decree 926/1998. As a bankruptcy remote entity, its activities are limited to achieving its primary purpose, i.e., the acquisition of specifically issued Cédulas and the sale of bonds. The fund is administrated by Ahorro y Titulización (Sociedad Gestora de Fondos de Titulización de Activos). This management company is supervised by the CNMV and is in charge of acquiring the assets (Cédulas) on behalf of the fund and of managing the fund. It also has a mandate to act on behalf of investors in order to implement the required formalities in the recovery process.

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Besides the mandatory overcollateralisation of the cédulas, AyT Cédulas Cajas Global has introduced several features optimising credit quality for the bondholders:

Liquidity Facility

A Liquidity Facility is in place to enhance liquidity in the event of default if the legal mechanism for cédulas does not provide sufficient funds in the very short term. Each tranche of notes issued under the programme has its own Liquidity Facility for both fixed and floating rate tranches of the notes, provided by Instituto de Crédito Oficial.

Protection Deposit

To further ensure that investors will fully recover principal and interest in the event of any issuer defaulting, the programme has set a minimum level of overcollateralisation (OC). Any issuer will have to maintain a Minimum Collateral Ratio, so that the pool acting as collateral for the Cédulas never falls below 150% of the Cédulas' notional value. This amount has been fixed for the life of the transaction, and, if the value of the collateral falls below this ratio, a Protection Deposit Mechanism is triggered. The Protection Deposit Mechanism provides that, if an issuer fails to meet the minimum

OC level, it is required to make a deposit with the programme's treasury account equivalent to two years' interest on all AyT cédulas issued.

Over the years, AyT Cédulas Cajas has become one of the main players among European covered bond issuers, as the chart below shows.

Rank	Issuer	Country	Jumbo volume in Eur Bn.	Market Share
1	Eurohypo AG	Germany	46,2	6,20%
2	AyT Cédulas Cajas	Spain	45,9	6,20%
3	Essenhyp	Germany	38,9	5,25%
4	BBVA	Spain	35	4,73%
5	CFF	France	31,9	4,31%
6	DG Hyp	Germany	30,4	4,11%
7	DEPFA	Germany	28,4	3,84%
8	AHBR	Germany	25	3,38%
9	Santander	Spain	24,5	3,31%
10	DEPFA ACS	Ireland	24,5	3,31%

As of December 31, 2006

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AyT Cédulas Cajas issue programme purports to make issues in the future in a constant and conservative manner, as it has done in the past: an example of this will be our next issue in USD which will probably take place in the first half of the year. A friendly investor approach is a key element of the strategic policy of the issues. AyT Cédulas Cajas has received several awards in recognition of its market-friendly approach such as best covered bond issuer of the year 2005 by EUROWEEK.

The Spanish economy is still one of the best within the EU and we believe that this is going to be the way things will maintain for several years, although the growth is slowing down. Regarding house prices the trend is changing slowly, confirming what some experts called "soft landing", once they have reached their peers levels. At the same time mortgage lending is also slowing down as a result of interest rate increases and housing prices consolidation. Thus we will have as a result less Cédulas' issuance volume, which we will see from now on: Spanish financial institutions will only fund mortgage growth and redemptions of existing issues.

MOLDOVA: GUIDING MORTGAGE MARKET DEVELOPMENT

Moldova: Guiding Mortgage Market Development Through Legal Reform

By Carol S. Rabenhorst and Nicoleta L. Mihalache ¹

The Context for Legal Reform of Mortgage Finance in Moldova

Introduction: A Growing Mortgage Market.

The mortgage market in Moldova has grown impressively over the last several years, and for the most part is developing along market-based, competitive principles. There are a number of established lenders making mortgage loans with reasonably long terms (10 years has become standard in the last year; one lender has a new 15-year mortgage product) at interest rates currently as low as 12% with special offers and generally about 14-15%. In most cases, interest rates are variable, but with interest rates in a downward trend, no bank reports a rise in interest rates in recent years. The size of loan amount to property value (LTV) is increasing, with 60-70% readily available to qualified borrowers for home purchase loans. Most private lenders rely only on the property as collateral; there is no system of third-party guarantees, large deposit accounts, direct withdrawal of salary, and other methods of security often used in other mortgage markets in the early stage of development. Most private lenders report little or no delinquency and no default in their current mortgage portfolios, in part due to steep increases in property values, particularly in the capital city of Chisinau where most of the mortgage market is located.

Overall economic indicators in Moldova are positive, with a generally increasing economy and decreasing inflation rates. A continued flow of remittances plays a pivotal role in sustaining housing consumption and the construction sector, with fixed capital investment up almost 20% in 2006². There is also a high level of demand for mortgage loans among the general population. Statistics kept by the larger real estate firms in Chisinau indicate that 60% of potential purchasers need a mortgage loan to purchase the home they desire. In this context, lenders, government officials and regulators, construction firms, and realtors are uniformly optimistic about the future of mortgage lending in Moldova.

Since 2005, international and local experts under contract to the European Bank for Reconstruction and Development (EBRD) have been working to assess the mortgage market and assist with reform of the legal framework for mortgage lending in Moldova. In late November 2006, they presented a new draft Law on Mortgage for consideration by government officials, members of parliament, bankers and other members of private and public agencies involved in housing finance.

This article examines the housing and mortgage sectors and the legal framework for mortgage lending in Moldova, describes gaps and other problems in the existing legal and institutional systems, and outlines

the steps that the international team has taken to address them through new and amended legislation and recommendations for additional policy and institutional changes.

Overview of the Housing Sector.

The recent history of the housing market in Moldova is typical of post-Soviet economies. Under communism, the means of production were almost entirely state-owned. At the time of Moldova's independence in August 1991, housing construction was hampered by severe shortages of building materials and disruptions in deliveries. Three hundred apartment blocks that were under construction at that time have never been completed. In 1990, private builders accounted for only 26% of housing construction in urban areas, but as much as 95% in rural areas³. Since then, new housing construction has fallen steadily from 24,000 units in 1990 to 2,900 units in 2001, almost all of the latter from private investment. A substantial percentage of urban units lack basic service infrastructure – between 20-25% lack in-unit water supply, sewerage, and central heat, 10% lack gas⁴. Per capita housing size is far below Western standards, averaging 57 square meters per apartment and 18.2 square meters per person⁵. Privatization of state-owned housing began in May 1993, with transfer to authorized

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² Moldova Country Report, Economist Intelligence Unit, Inc., London (2006).

³ Moldova Country Study, Federal Research Division of the Library of Congress, Washington, DC (1995).

⁴ Department of Statistical and Sociological Analysis, Republic of Moldova.

⁵ Average figures for the United States are 174 square meters per unit and 67 square meters per person, and for Western Europe, 91 per unit and 36 per person. Rector and Johnson, Understanding Poverty in America, Heritage Foundation, Washington, DC (2004).

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tenants free of charge for apartments that did not exceed the authorized per capita space utilization. People living in apartments that exceeded space norms were required to pay a premium to the state based on the average cost per meter of housing construction. Government-issued vouchers (Patrimonial Bonds), which were distributed on the basis of the number of years of a citizen's employment, could be used for that purpose. By 1999, 85% of the previously state-owned rental units had been privatized, and 92% of all households in Moldova lived in owner-occupied housing. There were approximately 1.3 million housing units in the country at that time.

In Chisinau alone, 120,000 families became private owners for the first time as a result of privatization. Privatized housing provided a quick jump-start to the establishment of a housing market, giving thousands of people a large amount of equity particularly in urban areas. Because the state-built apartments were small in size and usually in poor condition due to lack of maintenance under communism, privatization also increased demand for larger and more comfortable housing units. From 1999-2003, there were 533,000 property transactions in Moldova, with apartments accounting for the vast majority in Chisinau.

Prices of dwellings rose rapidly during the transition period due to inflation and other changes wrought by the change to a market economy, to about \$300 per square meter in 1997. After the region-wide economic crisis in 1998, prices fell back to an average of \$125 per square meter in Chisinau in 2000. Since then, prices have steadily risen to exceed the 1997 level, making housing one of the few mechanisms for wealth preservation for the average Moldovan family. In 2004, the price per square meter of a newly-constructed apartment in Chisinau was in the range of \$400-559⁷,

while that of previously owned apartments was \$380-450. Steadily increasing prices, caused by a stabilizing economy and limited alternative opportunities for savings and investment, have made new housing available only to the wealthy. The current situation has created classic circumstances for growth of the mortgage market, for home purchases, improvements, and commercial development.

Overview of the Banking and Mortgage Lending Sector.

The banking sector has undergone significant transformation over the past five years, with privately owned banks predominating. Although the banking sector remains relatively small and underdeveloped, with just five out of 16 banks accounting for 70% of total assets, the sector is essentially sound and well on the way to fulfilling its primary role in a market economy – financial intermediation⁸.

The banking system enjoys a high liquidity level and increasing customer confidence. Between September 30, 2005 and September 30, 2006, individual deposits rose 20.6% to over 8.3 billion lei (\$257 million). During the same period, net revenue of banks was 483.2 million lei, an increase of 37.4% over the previous year. Profitability of assets and of shareholder capital for the same period was 3.3% and 20%, increasing by 0.5 and 4.6 percentage points. Credit to the private sector grew in 2006 to 22% of GDP, up from 13% in 1999. Real estate, construction and development presently accounted for 9.2 percent of the total credit portfolio⁹.

In the last comprehensive assessment of the mortgage market, four out the five largest banks in Moldova were involved in mortgage lending, and most estimated that their mortgages comprise only 1-2% of their total loan portfolios¹⁰. However, one

mortgage lender reported more recently that it expects personal loans of all kinds, including residential mortgage loans, to account for about 13% of its total loan portfolio at the end of 2006; at the end of 2005, personal loans accounted for 3-4%.

As competition in the banking sector and institutional reforms result in better financing conditions, and as incomes continue to rise, larger segments of the population will gradually gain access to housing loans.

However, there are still impediments that restrain the large-scale growth of the mortgage sector in Moldova. The mortgage market is still excessively linked with the construction business, both among banks and state-supported housing institutions. Most construction lending involves large deposits (50%) to hold an apartment during construction, and requires full payment upon completion before ownership is transferred. Construction companies and lenders are transferring an excessive amount of risk to the purchasers who are inadequately protected in terms of completion of the property, timing of transfer, or ultimate purchase price. The budgets of the state and the municipality of Chisinau are unwisely providing untargeted interest rate and construction costs subsidies (through VAT exemptions), as well as guarantees of both pledges of purchaser's sales contracts and completion of construction. These subsidies benefit construction companies, banks and purchasers who could borrow on commercial terms. Government funds could be better invested in true credit enhancement for middle-income borrowers, such as mortgage insurance or guarantees for loans on commercial terms. There is also a misconception among some policy-makers and the public that the mortgage market can and should solve housing affordability and social problems for low-

⁶ UNECE, Housing Statistics Bulletin, Country Profiles on the Housing Sector – Republic of Moldova, United Nations, New York (2004).

⁷ Mortgage Transactions Reform in Moldova: Assessment of the Current Mortgage Lending Market, prepared by Progressive Banking Solutions, Ltd, Dublin, for EBRD (2005) ("2005 EBRD Assessment").

⁸ IMF/World Bank Financial Sector Assessment Program, January 2005.

⁹ Figures from the National Bank of Moldova, cited on the website www.economie.moldova.org.

¹⁰ 2005 EBRD Assessment.

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income families. With appropriate development, a commercially based mortgage market can be expected to result in lower interest rates and longer loan terms; these factors will expand the mortgage market to upper-middle income and probably to middle-income families as well as to the wealthy. Borrower-paid credit enhancement such as mortgage default insurance may, in a later stage, broaden the range of borrowers to lower-middle income borrowers. In the meantime, policies to foster a socially-based mortgage market

would require large government subsidies, which are neither affordable nor advisable. Notwithstanding preferences for homeownership, many households in Moldova do not have the income or savings to purchase a home or improve significantly on their current home. Despite some positive developments in the mortgage market in the past few years, high interest rates and short amortization periods limit the amount that can be borrowed. The table below¹¹ summarizes current lending conditions. Given the official income

distribution, less than 1 percent of households can qualify for a mortgage. However, actual income figures are probably higher than reported, and movement up or down the market is possible for the significant share of households who have mortgage-free ownership as a result of privatization. As the market becomes more competitive, lenders will probably be more likely to consider informal income and high equity in privatized apartments, as well as formal income.

Table: Mortgage lending conditions, 2006

	BCR	FinComBank	Victoriabank	Moldova-Agroindbank	Mobiasbanca with Bursa Lara	Mobiasbanca with the company Dragalina
Credit amount	Maximum LTV 70%	Maximum EUR 40,000	Maximum LTV 70% Up to US\$40,000	Maximum LTV 70% Up to US\$50,000	Maximum LTV 70%	Maximum LTV 50%
Duration	Up to 10 years	Up to 10 years	Up to 10 years	Up to 15 years	Up to 5 years	Up to 4 years
Usual Interest Rate	Un-restricted	19%	14%	15% (as low as 12%)	16%	16%
Commission	...	2%	0,5%	0,5%
Collateral	Mortgaging real estate	Mortgaging the real estate	Mortgaging real estate	Mortgaging real estate	Mortgaging real estate	Mortgaging real estate
Payment	Equal monthly payments	Equal monthly payments	Equal monthly payments	Equal monthly payments

The Current Legal System and Approach To Reform

In general, and in comparison to mortgage laws in other countries in the region at a similar stage of market development, the current laws in Moldova provide most of the necessary building blocks for a functioning mortgage market. The strength of the basic framework is evidenced by lender confidence and by the growing market in housing loans. The following elements of the legal framework are in place:

- Property rights are clear and well enforced, including the right to use property as security for a loan.
- Registration of titles and mortgages is

generally reliable, reasonably efficient, and moderately priced.

- Procedures are defined for foreclosure and eviction of debtors after default.
- Mortgage creditors have high priority in payment from proceeds of involuntary sale of collateral.

Notwithstanding the accomplishments of legal reform described above, current growth in the mortgage sector has come about despite the absence of a fully developed and cohesive legal framework. There is widespread concern among persons active in the mortgage market that the current laws will not adequately meet the demands of rapid growth, especially if the market is to include low-middle and

middle income borrowers as well as the wealthy. Because the mortgage market is so new and defaults have been very few, the legal system remains largely untested, particularly as it relates to foreclosure and eviction. Some court intervention is required in all cases; although expedited procedures are provided, it is unclear how well they will work and how readily judges will enforce creditors' rights. It is axiomatic that efficient procedures for seizing and selling collateral after default must be available to lenders for the primary market to expand adequately in response to demand, and for the secondary market to develop. In addition, the current laws do not adequately provide for construction lending, or for mortgages on apartments in multifamily buildings.

¹¹ Figures from authors' interviews and data published on www.habitatmoldova.org, September 2006.

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Preparation of a Comprehensive New Mortgage Law.

Substantial reform measures have already been adopted to improve the effectiveness of individual parts of the system, such as those relating to property registration, enforcement of mortgage contracts, and pledge of immovable property under security agreements. However, this approach has left the legal framework for the mortgage sector as a patchwork of laws, including the Pledge Law, the Law on Registration of Immovable Property, the Civil Code, the Code of Civil Procedure, the Execution Code, and a number of others.

The Ministry of the Economy and Commerce (MoEC) is leading government efforts to prepare the mortgage market for expansion. Among the donor community, the European Bank for Reconstruction and Development (EBRD) has taken on the task of providing expert assistance with legal reform, beginning with preparation of a comprehensive new Law on Mortgage, which was presented to MoEC for its review in November 2006. It is widely believed among Moldovan bankers and policy makers that a new Law on Mortgage will improve and clarify the fundamental principles and rules governing the primary mortgage market, which in turn, after further market growth, will help with the development of a secondary market. In addition to resolving specific legal issues, the new law will raise the profile of mortgage lending, and serve to increase confidence in the reliability, transparency, and accessibility of the mortgage finance system. It will also demonstrate the Government's commitment to providing the necessary building blocks for an efficient sector, and level the playing field by allowing fair competition among all lenders.

In addition to a new Law on Mortgage, amendments to other laws relevant to the mortgage sector and recommended adjustments to parts of the regulatory framework will be provided by EBRD, along

with recommendations for reforming systemic impediments to the primary and secondary markets which will need to be addressed if the new law is to bring the benefits that are anticipated for better access to housing finance in Moldova.

The approach to drafting the new draft law followed these key principles:

- The legal terminology and documentation is to the extent possible the same as what is already in place in Moldovan legislation. The objective of this approach is to be minimally disruptive to the existing legal framework while providing the consolidation and necessary level of detail for the mortgage finance regime to develop.
- The Pledge Law will remain as the general law addressing security rights over both movable and immovable property, with necessary amendments and adjustments, but section 3 of the law will be repealed with a cross-reference with the new Law on Mortgage, which will thus be *lex specialis* to the Pledge Law. The Civil Code provisions relating to mortgage lending will remain in force, with minor amendments when necessary, and conformity with its principles in the new Law on Mortgage will be observed¹².

Gaps in the Current Law Addressed in the Draft Law.

Certain specific problems identified in the current legal framework, or resulting from the absence of provisions in existing laws, were specifically addressed by the new draft law. These include the following:

The definition of "mortgage loan." In current practice in Moldova, a mortgage loan is a credit for the purpose of purchasing newly constructed or existing housing, with a security right on the title of the housing unit serving as the security for the loan. Commercial loans used for other purposes can also be secured by residential real estate. These loans, often called "home equity" loans in other markets, allow the

borrower to use ownership of a home for business investment or to pay personal expenses. In Moldova, there is uncertainty about whether these are mortgage loans. This uncertainty arises in part because the law in neighboring Romania makes a clear distinction between the two types of loans based on their purpose, what institutions can make them, and how they are regulated.

In most countries, any qualified mortgage lender may provide these two types of mortgage loans, and they are all qualified as "mortgages." Because mortgage loans for business or other personal purposes may be somewhat riskier, lenders can make them on less favorable terms and regulators may regard them differently for risk management purposes. But there is no reason for basic terminology in a law on mortgage to make this distinction.

In the new law, the definition of mortgage loan includes any loan secured by immovable property that remains in the ownership of the borrower. The law would not distinguish based on the purpose of the loan.

Institutions eligible to make mortgage loans, regulation of all mortgage lending activities, and consumer protection. Banks, financial institutions, and firms in the business of making loans but not taking deposits may all be mortgage lenders in Moldova, but non-depository institutions are not currently supervised by any government agency. While non-depository institutions do not need to be regulated from a prudential or risk-management standpoint to protect depositors, their mortgage lending activities should be supervised and regulated. Capital and risk assessment requirements should be imposed to protect the institution's investors and as part of the overall supervision of a healthy, stable mortgage market. Consumer protection and reporting requirements applied to banks or other financial institutions should apply in the

¹² This approach was similar to the one adopted in neighboring countries which have recently undertaken mortgage law reform. In Romania, the Mortgage Loan Law, No. 190/1999 as recently amended, is *lex specialis*; and the Civil Code remains in force as *lex generalis*. In Ukraine, the Law on Mortgages, effective January 1, 2004, is one of four laws regulating mortgage transactions. This law is treated as *lex specialis*. It amends various previous old laws, and explicitly abrogates Section II of the Law "On Pledge," which regulated mortgage issues before the Law on Mortgages took effect.

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same manner to non-depository lenders.

At the present time, property owners in Moldova are often poorly informed about their rights as mortgage borrowers. For most citizens in Moldova, as elsewhere in the world, their home is the largest asset they will ever own. Information about their rights and obligations as an owner is especially important in the context of mortgage borrowing, when they are at risk of losing their ownership rights if they violate the terms of the mortgage contract. Given the length of time the mortgage loan will be in effect, the relative cost, and the complexity of the contract, information in a form that is easily understood is essential.

Whether the National Bank of Moldova regulates and supervises all mortgage lending or another agency regulates and supervises non-depository institutions is a decision to be made by policy makers. Planning is now underway to create a unitary financial supervisory and regulatory body in Moldova, but it is expected that the National Bank of Moldova (NBM) will continue to regulate banks.

Recommendations in the draft law: The EBRD international team recommended that mortgage lending activities of all entities – banks, financial institutions, and non-depository lenders – be regulated and supervised. Mandatory consumer protection measures are included in the draft Law on Mortgage and applied to any entity offering mortgage loans, to be enforced by the NBM and/or any other supervisor. These include disclosure of information in plain language regarding loan terms, interest rate ceilings, and other costs of borrowing (such as prepayment and/or

arrears fees) in the mortgage contract. Marketing materials of the lender must not contain misleading or incomplete information. Borrowers should be entitled to a written explanation in plain language of the terms of the contract, including enforcement procedures, should be entitled to receive from the lender an annual mortgage statement, and other matters of concern to the borrower¹³.

Title and Registration of Apartments under Construction. Most of the mortgage lending in Moldova involves apartments in the 'condominium' form of ownership, both those that are in newly constructed buildings and those in privatized buildings previously owned by the state. A condominium is defined by its relevant law (in Moldova, the law dates of March 2000) as immovable property including land and living spaces where parts of the property are individually owned and the remaining parts are in undivided co-ownership by the individual property owners¹⁴. Each individual apartment together with its appurtenant share of common property constitutes a parcel of real estate for registration, taxation, transfer, and other purposes¹⁵.

In Moldova, title to an individual apartment is not registered in the cadastre until the apartment is completed and certified for occupancy. Purchasers are usually required to enter into "investment agreements" and pay the full purchase price before construction is complete. This either constrains the construction of real estate or requires banks to take of risk of lending without proper registration of the apartments. Banks have tried various methods of lending for apartment purchase,

including registration in the registry for pledges over movable property of an interest in the buyer's investment agreement, and making loans secured by another piece of property. But the inability to register interests in incomplete apartments in the cadastre puts both the borrower and the lender at increased risk in cases where construction is never completed or the quality of the construction is substandard. Lenders even express concern that the developer may sell the same property to another purchaser, leaving the lender with no security for the loan.

Recommendation in the draft law: Following the practice used in developed economies and in most of the transition countries in the region, the international team recommended that the developer of multi-unit housing must file a condominium plan, including a physical plan of the property, before any units may be sold. When the cadastre registers the building, usually in the ownership of the developer, it will assign a separate parcel number or sub-number to each apartment. As each apartment is sold, the transfer of ownership will be noted in the cadastre. This will allow interests in units, such as sales contracts or loans to be secured by the apartment, to be registered during construction. This will require amendment to the Law on Registration of Immovable Property.

Mortgage Enforcement. Moldovan law has undergone substantial reform in recent years with regard to the lender's rights to enforce a mortgage contract after default. The laws provide clear rights to a first priority for access to the proceeds of a forced sale, and the ability under most circumstances to foreclose and sell

¹³ The consumer protection legislative package enacted by the European Union provided a model. See European Commission C (2001) 447, Voluntary Code of Conduct on Pre-contractual Information for Home Loans.

¹⁴ This is the ordinary definition under international best practices.

¹⁵ This is the case whether or not the owners in the building have formed an association to manage the common property. Such an organization does not affect the form of ownership in the building, but owners' associations should be encouraged to ensure proper maintenance and operation of the building, which will help maintain the value of the collateral in cases of mortgage loans secured by condominium property. Some banks in other transition countries where privatized housing is now owned in the condominium form but associations are optional, such as Armenia, will not lend unless there is a legally registered owners' association or other management entity to look after the common property in the building. The concept of the condominium ownership, at present in Moldova, seems to be underdeveloped and is not regarded as a separate form of ownership but rather as an institution that can be created by the co-proprietors of the common parts in a building. However, the practices related to condominiums in other frameworks can be adjusted to benefit the Moldovan construction sector and mortgage market.

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property used as collateral without court intervention and without burdensome auction procedures. While the legal provisions are probably adequate for a small market of carefully selected borrowers, they are likely to need improvement in preparation for a primary market open to a larger portion of the population and for initiation of a secondary market acceptable to investment. Many of the problems cited in mortgage enforcement are anticipatory, as there have been few enforcement actions taken against borrowers in current portfolios. These should be corrected, however, before the market grows much larger. Specific problems include:

Rights of debtors to challenge foreclosure. Lenders in Moldova can foreclose without litigation in accordance with procedures in the Civil Procedure Code and the Execution Code. The lender may obtain a court order of enforcement on an ex parte basis, which the debtor may challenge within days of receipt of the order. While the Execution Code lists reasons for the court to grant a stay of its order of enforcement, the court has substantial discretion about what constitutes good cause for suspension. Once the stay is issued, full litigation of the claim may ensue. This countermines the intent and purpose of the law giving lenders the right to seize and sell mortgaged property without court intervention, and the purpose of making the mortgage documents executive in nature. In most civil law countries, a notary certified document or claim may be taken immediately to execution if the debt is unpaid, with limited defenses available to impede the creditor's right to speedy resolution.

Recommendation in the draft law: The draft law provides that the debtor must present evidence that: (a) the formalities of initiating enforcement have not been observed; (b) the contents of the notification sent to the debtor were erroneous; or (c) the debtor has complied with the conditions required by

the lender in its notification letter. The international team recommended these limitations to prevent a debtor with a sympathetic judge from stopping a foreclosure for personal reasons such as illness, inability to pay, loss of employment, and the like¹⁶.

Eviction. The draft law clarifies the creditor's right to take over the property free of occupants after foreclosure. Occupancy rights (except in the case of a tenant with a valid lease) shall be extinguished upon termination of the debtor's rights through foreclosure and forced eviction may be carried out 15 days after entry of the foreclosure.

Non-Legal Issues Relating to Enforcement. Other issues relating to enforcement of mortgage rights cannot be solved per se by a new law on mortgage, but should be kept in mind by policy makers and supervisors as the market develops. These include:

- Lack of experience. This results from the lack of defaults in current portfolios of mortgage loans. There is wide divergence in opinion about how long it would take to foreclose and sell property securing a mortgage loan, ranging from two months to three or more years. The timing is unpredictable in any case because of inability to foresee whether the debtor will raise a challenge in court and force the matter into litigation¹⁷.
- Concerns about court efficiency, judges and enforcement officers. There is a widely held view that courts in Moldova are too slow and will refuse to allow foreclosure when the debtor presents a sympathetic story in his defense, especially when there are children in the household. This thinking may be a holdover from socialist days when housing was regarded as a virtually inalienable right, and can be best resolved by training and public information to

increase awareness of the effects of lax enforcement – lending becomes more expensive for all if the few who do not pay are allowed to avoid their obligations.

Lack of Standardization. For a number of reasons, there is little demand for a secondary market to finance mortgage loans through the capital markets, either on the part of banks or potential investors. This is not surprising at the current stage of development of the Moldovan market. Banks are highly liquid, there is a large margin between cost of funds and mortgage interest rates (usually at least 7%), and deposit bases are growing rapidly. However, banks and other lenders should begin to adopt standardized loan documents, underwriting and servicing procedures, and minimum quality standards and terms now, while the market is growing rapidly. This will create stronger loan portfolios and establish mortgage pools that will be qualified for mortgage-backed instruments in the future.

Recommendation in the draft law: The draft law prepared by the international team requires a number of elements necessary to create higher quality and more standardized loans. These include: independent appraisal of property used as mortgage collateral; replacement value property insurance for the collateral; life insurance for the borrower if the loan agreement requires.

Other Issue for Future Secondary Market Development

Historically, the development and implementation of a secondary market legal and regulatory environment in emerging economies has a long gestation period during which the primary market grows and becomes increasingly organized. It is prudent for regulators and lenders in Moldova to look ahead to such development while the primary market is still developing and efforts are underway to

¹⁶ Strict procedures also protect the debtor as well as the lender. Experience in other countries show that the longer the court procedures before sale of the property can occur, the greater the diminution in the value of the property upon sale. Lengthy procedures make it less likely that either the borrower or the lender will be made financially whole after default.

¹⁷ The only reported experience to date relates to foreclosure of loans relating to residential property where the loan was used for commercial.

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properly legislate and regulate the primary market. This will provide mortgages that meet the high standards of quality necessary to attract investors in mortgage securities. Moldova must overcome the following impediments for the secondary market to develop:

Insufficiently Developed Primary Market.

Although there has been an impressive growth in the Moldovan mortgage market in the past several years, the primary market is still in the embryonic stages. Secondary market investors can assess risk only from the data and assurances provided by the primary market. Investors rely heavily on historical data, provided either directly by originators or through a credit rating, in deciphering whether to invest in the secondary market. Such data (e.g. relating to defaults and delinquencies) is truly applicable only when there is scale in the primary mortgage market that has undergone at least one real estate cycle. Further, scale is also very important because developing secondary market instruments such as bonds or mortgage-backed securities can be expensive; this requires certain volume thresholds to justify associated costs.

Lack of Present Demand. Development of the secondary market is also heavily dependant upon demand for long-term capital markets instruments such as mortgage-backed securities. Such demand must be vetted as to the types of investment instruments (i.e. tenors, pricing and risk appetite) prior to the development of the appropriate product for the secondary market. In other words, the supply side must match the needs of the demand side. Currently in Moldova, there is a lack of demand for MBS type of products due to high liquidity in the market, immature bond markets and absence of key institutional investors such as private pension and mutual funds. On the positive side, there is some demand among institutional investors such as insurance companies to invest in MBS type of products.

Lack of Standardization of Other Market Functions. An efficient and vibrant secondary market can be achieved only through the development of recognized standards in the market. Standardization not only in the underlying mortgage legal documentation, but also in property valuation methodology and appraisal reports, credit reporting, title and registration processes and documentation, and gathering and transferring of relevant data, is among the major aspects of the primary market that needs to be encouraged in Moldova in preparation for the secondary market.

Inadequate Legislation/Regulation of Relevant Sectors.

Whereas domestic institutional investors such as insurance companies and pension funds would be the prime purchasers of mortgage-based securities or similar instruments, the current legal and regulatory framework prohibits insurance companies from investing in financial instruments. There is a need to develop a regulatory environment that facilitates the entrance of insurance companies into the capital markets and formation of other similar participants, such as pension and mutual funds. At present, there is inadequate or inappropriate legislation and regulation of the capital market, and insurance and pension sectors.

Conclusion

The mortgage market in Moldova is growing quickly and is developing along market-based principles, with expanding competition and a stabilizing economy resulting in increasingly favorable terms for qualified borrowers.

In terms of the legal environment, Moldova has reasonably strong enabling laws, but the absence of a comprehensive Law on Mortgage may hinder future growth of the market. Inconsistencies among the various applicable laws create confusion among actors in the sectors. Commercial lenders have adopted different and potentially risky procedures to compensate for lack of clarity

in the law, particularly with regard to the large part of the sector relating to lending for construction or purchase of apartments under construction. A new draft Law on Mortgage, now under consideration by the Government of Moldova, has been prepared to help resolve those problems, and will place Moldova in a stronger position for robust growth of the primary market and development of a sound secondary market.

However, the procedure for these loans is the same as for "mortgage loans," and bankers report that these foreclosures and property sales went reasonably smoothly.

THE CURRENT STATE OF UKRAINE'S MORTGAGE MARKET

The Current State of Ukraine's Mortgage Market

By Yevhenia Dyad'ko and Gary Roseman

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Introduction

The precondition for the mortgage market was the privatization of residential property, meaning apartments for most urban residents, at the time of the break-up of the Soviet Union. Ukrainians gained the right to privatize their dwelling places by completing the necessary forms. By the end of 2000, over half of the residential space in Kiev was privatized¹.

Construction loans, which are collateralized debt obligations with high interest rates, existed before proper mortgages in Ukraine. Mortgages first became significant in the banking sector in 2002. At the time, six commercial banks, including the six largest in terms of assets, participated in the mortgage market. These banks did not extend credit beyond five years and rates were from 14-18% annually for dollar credit and over 25% for hryvnia (local currency)

credit². Rising incomes during the years of rapid economic growth enhanced consumers' abilities to service long-term debt and their willingness to assume mortgages increased. Further stimulus came with the passing of the Law on Mortgages in 2003. This law increases creditors' security over previous legislation and clarifies some aspects of the mortgage agreement, such as dispute settlement, forms of the mortgage agreement, though some deficiencies remain on issues like foreclosure. At the present time, nearly 100 banks in Ukraine offer mortgages. The largest mortgage market participants among these banks are in the following table.

Major banks involved in the mortgage market

Bank	Share of Mortgage Market
UkrSibBank	14.98%
UkrSotsBank	13.98%
Aval	12.95%
PrivatBank	12.76%
Raiffeisenbank Ukraine	8.68%
Praveks-Bank	8.34%
Nadra	4.12%
Financi i Kredit	3.52%

Source: *Gazeta Biznes*, no. 21 (696), May

22, 2006, p.59

These eight banks account for over 75% of the mortgage credit extended by January 1, 2006. In terms of asset size, seven of these banks are the largest non-state-owned banks in Ukraine³. Unlike in Russia, where three of the top five banks in capitalization are state-owned, all of these banks are publicly traded banks, several with West European partners⁴.

Impediments to Growth

Several impediments slow the growth of the mortgage market. Several factors common to other post-communist societies are present in Ukraine, such as inadequate condominium legislation and land use rules and poor municipal services, which impact the value of an object to be mortgaged. These factors can and are remedied by governments. However, even with the progress in Ukraine, legal inconsistencies that limit mortgage development exist. For example, the Law on Mortgages has provisions for foreclosure but they conflict with various components of other laws, such as the Law on Families, which can be interpreted to prevent the foreclosure on a property where children are residents. Securities laws are often restrictive because of past experience with financial pyramid schemes, and when they are liberalized, as

¹ Roseman, Gary, "Ukraine's Developing Mortgage Market," Southern Business Review, vol. 28, no. 2 (2003), and Kiev Municipal Board of Statistics, Kyiv u Tsiphrakh (2001), p. 149, 214.

² UkrSotsBank report (2002), "Rynok zhlischynovo kredit," p. 5. Meanwhile, interest rates have decreased, as seen in the further parts of the article.

³ According to the Ukrainian Association of Banks, published as "Rezultati diyalnosti ukrainskikh bankiv za I pivrichchya 2006 r." Delo no. 129 (181), July 25, 2006, p. 13. Praveks-Bank is the only leading mortgage lender not in the top ten in asset size; it was 24th in the Association's ranking. Among the top ten banks in asset size in Ukraine, two are state-owned. None of the other banks in the top 20 are state-owned.

⁴ BNP Paribus owns 51% of UkrSibBank, Raiffeisenbank Ukraine is a subsidiary of Austria's Raiffeisen bought a majority stake in Aval, before being bought by Hungary's OTP Bank. Intesa Bank of Italy announced plans to purchase a majority in UkrSotsBank, though Italian regulators have scrutinized this proposal.

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in the case of provisions for mortgage-backed securities, enabling legislation may not exist.

Another limitation on growth is the lack of information about credit histories. Because credit bureaus are just developing in Ukraine, with one expected to begin work by the end of this year, bankers must produce their own information to assess a potential borrower's creditworthiness⁵. A potential borrower will complete forms requested by a bank providing employment references. The current process involves a labor-intensive process of verifying employment, work performance, and income range. The latter is not precise as Ukrainians often conceal income for reasons of tax evasion and avoidance of becoming a desired target for criminals. Because of the imprecise nature of income estimates, some smaller banks will extend credit only to employees or owners of enterprises which have accounts with the bank. Even with bureaus, the limited formal credit histories of many potential borrowers will reduce the potential informational value from credit reports for the near future.

Because of the lack of information about past histories, banks must produce more of the information necessary for the credit decision than Western banks do in their credit processes. When applying for a loan, a borrower will generally bring the domestic passport, which records relevant information like place of residence, work, marital status and dependents, as well as the taxpayer's identification code, and certification of employment and income, which will be verified by the bank's security service. According to loan managers in several banks in Dnepropetrovsk, borrowers can usually expect approval within five to seven working days. Banks will order appraisals from preferred appraisal firms, which are licensed after meeting requirements based on international norms

and examination processes in the profession. The information from the appraisal is usually a matter of strict confidentiality.

Finally, an impediment exists in the short-term nature of banks' liabilities, which limits the ability to acquire long-term assets like mortgages. Short terms for credit are common without a secondary market mechanism. As long as banks cannot sell mortgages, they remain expensive to consumers. Smaller banks, in particular, will extend credit for only three to five years because of the difficulty in attracting deposits to match the long-term loans. Larger banks advertise mortgages for terms up to 20 years for dollar or euro loans and 15 years for hryvnia loans, though the average term is much shorter for loans in all currencies.

Terms in the market

In the summer of 2006, interest rates ranged from approximately 12% on an annual basis for dollar and euro loans to nearly 17% for loans in hryvnia. These rates are high and recent Ukrainian Eurobond interest rates have been lower. Problems with legislation for creditors' rights explain some of the risk premium included in these high rates, and the local currency rates reflect a lack of confidence in its long-term stability, even though the National Bank of Ukraine's record for the past eight years has been impressive. Variations in loan origination fees, insurance fees, notarial service fees, and the amount of down payment explain small differences between banks' published interest rates. Local branches have little ability to adjust rates or down payment amounts set by the bank's central office. That is, a flexible concept of points is not practiced in the mortgage market.

Advertised Interest Rates for Mortgage Loans at Ukrainian Banks

Bank	Foreign currency	Hr
PrivatBank	12	12
Aval	12	16.5
UkrSotsBank	12	17
UkrSibBank	11.8	15.5
Raiffeisenbank Ukraine	12	15.5
International Mortgage Bank	12.5	

Source: Delo, no. 86 (138), May 23, 2006, p. 14

An important consideration when noting these interest rates is that the banks apply interest to the outstanding balance. Thus, the amount of monthly interest payments drop with accelerated reduction of the outstanding principal.

Banks insist that the interest rates do not vary between regions. However, differences exist in the maximum amount of credit available and the required down payments sometimes vary between regions. An explanation is the lack of information about the property markets in the regions, which often suffer population loss and economic malaise. The market in Kiev is growing and has attracted foreign interest, while regional cities, with some exceptions particularly in the industrialized eastern part of the country, have languished. This difference in economic growth has reduced banks' willingness to assume more risk through greater lending in some areas of the country.

Credit ceilings in a region are usually based on a local average price for new construction. For example, if average new housing costs \$1,200 per square meter and the average size is 100 to 150 square meters, then the maximum credit will be \$120,000 to \$200,000. If, however, a creditworthy borrower wishes to obtain a larger sum, the main office will need to approve⁶.

⁵ In June 2005, 30 banks formed the First All-Ukrainian Bureau of Credit Histories (PVBKI) with a goal of finding a strategic investor. Creditinfo Group of Iceland announced its involvement in spring 2006. PVBKI plans to start collecting credit histories by the end of 2006. The banks in the PVBKI have about 70% of credit to individuals. Roman Kovtun, "Pervoe v Ukraine kreditnoe byuro nashlo investora," Ekonomichiskie Izvestiya no. 100 (405), June 9, 2006, p. 5. The country's largest bank, PrivatBank, remains outside this group with its own developing credit bureau service

⁶ Banks have policies that require large down payments of typically 20% of a property's value. Credit ceilings generally are not expandable, even with lower LTV ratios, without approval from a bank's main office.

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Banks require the mortgaged property to be insured and most banks will require life insurance on the mortgagor for the term of the loan, as well. Some banks also require title insurance, especially as mortgagors show more interest in existing homes, where the chain of ownership since 1991 sometimes has some anomalies resulting from a change in the status of the real estate object (e.g. from communal to private) after large-scale privatization⁷.

Annual fees for life and property insurance range from one to three percent of the principal, respectively. Most banks have agreements with insurance companies to provide these policies to their clients, but all insist that a client has the choice of companies.

Distinctions in terms often exist for new and existing properties. Incorrect and falsified records of title transfer exist for existing structures. Many lenders consider new structures to be of lower risk because of the reduced possibility of contested title. However, even currently, banks often do not require title insurance in this market, leaving risk to the borrower, who is advised to insure against title deficiencies⁸. In the new home market, units sold are often "shells" that require outfitting with flooring, fixtures, and wall coverings. While loans secured by these properties are properly mortgages in the sense of being collateralized by an existing, alienable asset, the lack of occupancy increases the risk to the bank of an owner/non-occupant's default.

Payment procedures

Banks devise payment plans in consultation

with clients. Besides the accelerated payment approach, Ukrainian borrowers have the option of the amortization plan. This offers stable payments, but the sum of interest payments is greater than with an installment method, in which the borrower pays interest on the outstanding balance.

Payment is often in foreign currency. According to data from the Ukrainian National Mortgage Association (UNIA), the volume of mortgage credit in foreign currency, usually meaning US dollars, has risen from over 75% of the total to 85% of the total mortgage credit by the spring of 2006⁹. Reasons for the prevalence of dollar loans include, from banks and consumers, a familiarity with and availability of the currency¹⁰. Further, speculation of a hryvnia revaluation against the dollar has stimulated consumer demand for dollar loans¹¹. However, the long-term prospects of the hryvnia have led to provisions in contracts that place some of the uncertainty of hryvnia on the borrower with contractual provisions to raise the interest rates on these loans under certain circumstances, while dollar and euro loans are generally fixed rate.

Payment is due by a specified date in the month. Mortgagors commonly pay their obligations in cash at the bank; checks are rare in Ukraine and electronic transfers are not used. Much of the reason for this payment method is tradition but the continuing presence of irregular and undeclared sources of income produce a reluctance to use traceable forms of payment¹². Late payments usually incur a penalty of a given percentage of the amount

due, typically 0.5% or more.

Potential for Growth

With rising incomes and property prices, and growing familiarity with credit institutions, mortgages will continue to increase as a percentage of Ukraine's GDP. For comparison, the volume of mortgage debt in Ukraine, estimated at approximately 12 billion hryvnia, is about 3% of GDP, much less than rates in mature market economies and less than the estimate of not less than 5% of GDP in neighboring Poland. This suggests that the mortgage market will continue to grow, and many ancillary activities have also begun, such as refinancing. In this refinancing arrangement, the new bank and the original creditor agree among themselves to transfer the rights to the mortgaged property. However, sometimes the original creditor does not cooperate and the new bank provides temporarily unsecured credit to the borrower who then retires the original mortgage. Then the process follows with formulation of documents¹³.

Home equity loans, particularly for repairs and improvements, are also more common. Credit unions, a growing segment in the banking sector, specialize in these loans. From credit unions, the process is relatively quick for members but they pay 20-26% interest rates, while banks, with more intensive checks, charge 14-16%. The borrower's apartment is usually collateral but other arrangements are possible. Without collateral, lenders usually limit credit to 25,000 hryvnia¹⁴.

⁷ Interest rates on existing homes may be lower by about 50 basis points at some banks. The reason is the home is already built and habitable. The experience of Elite Center in Kiev, where builders absconded with large prepayments for a residential project, signaled a move to the existing homes. Tatyana Ochimovskaya, "Zaemshchik s titulom," Delovaya Stolitsa no. 27 (269), July 3, 2006, p. 9. For an account of the scandal, see John Marone, "Kyiv Housing Scam Raises Questions, Fuels Distrust," Kyiv Post, February 16, 2006.

⁸ Alla Berezovskaya, "Bankiry rekomenduyut inpotechnye kredity v dollarakh," Ekonomichiskie Izvestiya no. 105 (410), June 19, 2006, p.5.

⁹ Ukrainian National Mortgage Association (UNIA) first quarter report (2006), p. 20

¹⁰ UkrSibBank, majority-owned by BNP Paribas, announced Swiss Franc loans at 8.99% annually for terms up to 21 years. UkrSibBank Press Release, ⁷ December 29, 2005. The bank has reported little interest in these loans.

¹¹ Alla Berezovskaya, "Bankiry rekomenduyut inpotechnye kredity v dollarakh," Ekonomichiskie Izvestiya no. 105 (410), June 19, 2006, p.5.

¹² Irregular and undeclared sources of income from the informal sector or "gray economy."

¹³ Dmitriy Grinkov, "Razvod po-tsivilizovannomu," Delo no. 86 (138), May 23, 2006 p. 14.

¹⁴ Margarita Ormotsadze, "Remont v Dolg," Delo no. 112 (164), June 30, 2006, p. 14. The hryvnia's exchange rate was steady at 5.05 to one U.S. Dollar in the summer of 2006.

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Conclusion

Several motivating considerations for the development of Ukrainian mortgages exist. The first is the deficiency in the availability of fixed income assets. The country's growing pension funds are looking for domestic assets to avoid the currency risk inherent in holding foreign assets¹⁵. Also, the availability of debt instruments will increase Ukraine's ability to maintain a capital account surplus, which is necessary to finance the modernization of its industries. Debt is cheaper for firms than equity, it is less susceptible to contagion, and control issues are less intense for the investor with debt than equity, making mortgage market development attractive for foreign investors who would be important in promoting the capital account surplus. Thus, mortgages are a necessary part of Ukraine's macroeconomic progress.

Because of the short-term nature of the banking system's liabilities, banks' abilities to acquire long-term assets like mortgages are impaired. A remedy is possible in a secondary market, as has been done in Kazakhstan¹⁶. However, the entity charged with the genesis of the secondary mortgage market in Ukraine, the State Mortgage Foundation, has been accused of mismanagement of funds and slowness to provide details to Ministry of Finance in connection with the Ministry's offer of guarantees¹⁷. Only after continued application did the Ministry of Finance finally give approval for the guarantee of 1 billion hryvnia in bonds of the State Mortgage Foundation¹⁸.

Secondary mortgage market financing will provide the country's financial institutions with a method of transforming short-term deposit liabilities into long-term loan assets. One general model for achieving this transformation is that of mortgage-backed securities (MBSs), as in the United States, and an alternative model is mortgage bonds as used in Continental Europe¹⁹. The MBS option involves the purchase of mortgage loans from banks by a special purpose vehicle (SPV), which in turn pools the loans and sells securities representing ownership in the pools. Such a model requires a rating system to assess risk of the securities. In the mortgage bond model, the lender sells bonds linked to its mortgage assets and continues to bear the risk of default. Historically, these bonds were available to small investors who could scrutinize the lending policies of the bank which issued the bonds. With no role for a special purpose vehicle to pool and securitize the mortgages, the need for establishing a new entity (the SPV) is eliminated and the numbers of transactions and contractual relations decrease, thereby reducing the potential requirements on the legal system in comparison to the MBS method of financing. Additionally, with the high interest rates that borrowers currently pay, the secondary market model must address pre-payment issues²⁰. At this stage in Ukraine's financial market development, the mortgage bond system, with its comparable simplicity, may be the preferable model for market mortgage financing. The structure and the design of such a funding mechanism, however, require further research and discussions.

¹⁵ Losses from holding dollar-denominated assets in the event of a Ukrainian currency appreciation against the US Dollar are possible.

¹⁶ "Small but Elegant: Finance in Kazakhstan," *The Economist*, May 29, 2003. Unattributed news item.

¹⁷ Yuriy Gusev, "Ipotechnaya zaryadka," *Gazeta Bizness*, May 22, 2006 no. 21 (696), p. 58.

¹⁸ "Minfin razreshil GIU privilech 1 milliard Hr. pod Gosgarantiyu," *Ekonomichiskie Izvestiya* no. 99 (404), June 8, 2006, p. 5. Unattributed news item.

¹⁹ Please see Ricardo Giucci and Ihor Eremenko of the German Advisory Group on Economic Reforms and Institute for Economic Research and Policy Consulting, "Mortgage Lending in Ukraine: Three Strategic Questions and Answers," and Tim Lassen of the Verband deutscher Hypothekenbanken, "Einführung von Hypothekenobligationen in der Ukraine," in *Mortgage Lending in Ukraine: Proceedings of the Roundtable* Organized by the Institute for Economic Research and Policy Consulting and the National Bank of Ukraine Center for Banking Policy Research, Kyiv, March 2004.

²⁰ The Danish mortgage bond systems allows for pre-payment. The borrower can either buy his bond in the market or pre-pay his loan. The German Pfandbrief system typically does not include floating rate notes. It serves to finance loans with fixed interest rates. Pre-payment is only allowed against high penalties.

HOUSING THE NO-INCOME GROUP

Housing the No-income Group

The role of Housing Finance in Alleviating Urban Poverty

By N.O. Jorgensen, consultant on urban economics and finance

Introduction

The debate about "affordable housing" for the poor has still not advanced beyond dealing with those groups who can pay for decent shelter out of past or current income. Regrettably, this leaves out those most in need of improved shelter. If the debate on this topic could be advanced in the relevant journals and meetings, efforts to help where it matters most could perhaps be enhanced to an extent and in a fashion where the poor could begin to see some significant results of the much touted "Habitat Agenda"¹. This agenda aims to provide "adequate shelter for all" but conveniently leaves out a deadline. In contrast, the Millennium Development Goals (MDG)² is more specific on dates but vague on measurable results: "By 2020, to have achieved a significant improvement in the lives of at least 100 million slum-dwellers". Apart from the obvious benefits of improved shelter, house-ownership is arguably also the most effective way of alleviating urban poverty and, like improved shelter, particularly favours the poor. Still, housing the very low- and no-income group is usually left out of policy statements such as the two mentioned above. National housing policies typically deal only with "moderate- to low-income housing" without being specific, implying or even saying so explicitly that those who can't pay for a decent shelter financed on market terms must be subsidised. However, the trouble

with subsidies is that there is never enough money to reach all those entitled, and that whatever subsidies are given often end up benefiting the "middle- to higher income" individuals. The results of these policies are well known: Plenty of houses for the rich, less so for the middle class and huge areas of squatter settlements for the poor around most major cities in developing countries.

In order to place the ambitious - some will say utopian - topic of this article in the proper perspective, it is necessary first to outline some commonly accepted premises.

PREMISES

The main premise on which the proposition is based is fairly simple: Demand for space of poor families far exceeds supply. As a result, these groups cannot afford these prices. Although such an investment seems to be profitable, the inherent should be not neglected. For example credit risk could be of considerable concern because of the instable incomes.

Although the emphasis in this article is on HOUSING, the overall aim is to alleviate POVERTY in urban areas and the operative technique is FINANCE. Whether some poor families choose to become house-owners or remain as tenants is immaterial. The result will be a net addition to the housing stock. Also, if some no-income families

decide to sell their access to a house because they have other priorities, at least it helps in alleviating their poverty.

Another premise is that the housing situation in poor countries is desperate, not only because of a shortage of shelter, but because so much of the existing shelter stock is grossly inadequate in terms of space, materials, privacy, infrastructure, security of tenure, good governance, etc. Yet, the prices poor families pay for whatever they occupy is very high relative to their income. Surveys have documented³ that "rent propensity" i.e. the part of income a family pays for housing out of current income is about 15% for higher income groups, ca.25% for those in the middle and up to 50% for the poorest. This parameter is, contrary to popular opinion, determined more by shortage of supply relative to demand than by size, location and quality of shelter for the poor. This fact has been documented by surveys of slum areas of family expenses on housing over time.⁴ Rent propensities stay fairly constant regardless of gradual improvements to structure and infrastructure, because family income normally increases over time – though not uniformly by the rate of inflation – and because the relative housing shortage persists.

Any investment in this segment of the housing market is therefore very profitable. However, as a rule the cost of "adequate

¹ 1 The Habitat Agenda was adopted by 171 governments at Habitat II, Istanbul, Turkey, 1996.

² The MDG was agreed by the UN General Assembly in 2000

³ N.O. Jorgensen (1975) in "Housing Finance for Low-income Groups" where rent propensities ranged from 50% for the poorest deciles of the population down to 12% for the wealthiest.

⁴ P. Amis (1984) in "Squatter or Tenants" World Development 12, p.87- 96 who points out that rent propensity remains virtually unchanged over time for the same two deciles.

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shelter" is far more than poor families can afford, particularly since they do not normally have access to housing finance which spreads payments for such a housing unit over many years. Therefore, they cannot make an investment in an income-creating asset which also serves them as shelter while they repay the loan. The operative concept here is the income-creating potential of housing. In commercial circles this is the prerequisite for an investment and is facilitated by housing finance institutions in rich and poor countries alike. The question is: Who will do it for the poor families who find themselves as "defaulters before the event" when approaching these same financial institutions and are told that they cannot afford a loan which requires them to pay more than 33% of their income to amortise such a loan. Their insistence that they are already paying 50% in rent has no effect. Moreover, there is normally the understandable but prohibitive requirement of having to make a down payment of 10% - 15%. As a result, which options are available?

OPTIONS

Governments have, on the whole, let "status quo" prevail, allowing elaborate housing surveys and policy documents become substitutes for implementation. Meanwhile, the housing problem keeps growing. Huge amounts of foreign aid, well-intended inputs from international agencies and constant reshuffling of public budgets have not made much difference to the overall situation. Other options are called for. The private sector, not surprisingly, shows the way. An example will illustrate this:

A major International company operating in several developing countries decided that their present staff quarters in Nairobi (Kenya) were inadequate (mainly one-roomed units in 3-storied blocks with communal bath and toilet facilities). A competition was announced with a brief which, inter alia, called for units for all staff categories not costing more than 1/3 of the individuals' gross income on normal mortgage terms. All the submissions except

one stated that it could not be done, as even land and infra-structural cost would exceed the stated rent propensity of the two lowest staff categories (cleaners and messengers). Various subsidies were suggested but not accepted. The winning solution proposed to build 5-roomed houses also for the lowest paid workers, albeit of a more modest kind, so that they could initially live in one room and let out the other four, and pay slightly less than 33% of their income. As their income from work and rent increased (with inflation) and loan repayments stayed constant, they could, if they so wished, take over more rooms for their own use, eventually making the house a consolidated one-family 5-roomed unit.

Because demand for rental units in Nairobi far outstrips supply, return on investment in construction of shelter for the poor - and not so poor - is very attractive. A simple calculation illustrates the economic viability of this approach: If every room in a 5-roomed house rents for \$20 per month, the revenue can amortise a loan of \$9,820 over 30 years at 12% interest. The three variables: loan maturity, interest rate and rent level may vary elsewhere and therefore influence the loan sum, but the same principle applies to all cases. The variables will be discussed under "Finance" below in relation to design, materials, infrastructure and the possibility to grant a loan covering the whole cost of the purchase (LTV ratio of 100 %). However, in order to accommodate the "no-income" family, two extra rooms must be added of which one will be occupied by the owner. Since only six rooms are let the loan sum will be \$11,780 which is a realistic option in most poor countries provided minimum standards are allowed and many units e.g. blocks of flats are built in the same project. In any case, it will be a significant improvement on whatever that no-income family is presently occupying. The same principle of gradual occupation of more rooms over time applies. But as rents increase and the family starts to create more income through (self) employment while loan repayments stay the same, it could be a requirement, if the borrower becomes an absentee landlord, that the loan be repaid sooner in order to

generate more capital for new construction. BAT Kenya Ltd. executed the project and Housing Finance Company of Kenya (HFCK) provided the long-term finance. It is HFCK's policy to shorten the lending period for rental properties.

This somewhat simplistic illustration of a real project deserves to be analysed and argued from several points of views, in particular to convince those who have a vested interest in preserving the status quo. Though the concept is simple, the solution(s) are not necessarily so. In fact, the implementation will require the imagination and skill of the best professionals from architects and planners to economists and environmentalists. The argument that these specialists are not available in poor countries is not true. The number of professionals is not the issue. Given the challenge, talents will emerge. They certainly did in this project mentioned above. In addition the location of the project turned out to be a very popular place to live. Since residents had a common bond through their employment several community-based activities and improvements have been implemented. Granted, the local housing finance institution was positive from the start by virtue of dealing with a defined group of borrowers all working for, and being guided by, a major company without which the land may not have been leased from the Government. Although the project executor undertook construction finance, he did not offer guarantees for the individual mortgage loans.

There were, of course, practical issues as well as some of principle. For instance, should the owners be allowed to capitalise on their new status as owners by selling the units immediately or soon after completion? Alternatively, should they be allowed to rent out all the rooms and continue living where they were? If selling, should the units be sold back to the employer for resale to other staff who wanted to occupy them, in whole or in part? These questions were fortunately resolved during project preparation through a great deal of consultations with future owners - and it

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was decided that staff members are individuals capable of deciding on the relevant priorities. Therefore it is assumed that they know how to exploit this "fringe benefit" from their employer. It also saved management numerous headaches trying to implement such restrictions while, at the same time, creating staff loyalty, respect for management and enthusiasm for the project. Among the practical issues, other than finance, which ought to be dealt with in this context are: Land, Tenure, Planning, Design, Materials, Infrastructure, Environment, Safety, Administration and Community Development. Fortunately, the literature is now extensive on most of these topics. It is sufficient therefore to point out that it is imperative that all of these aspects are considered. However, six of the above areas of concern have been singled out for special, if brief, mention, because they relate directly to accessibility of finance

1. Land

Land has a cost (rent in case of leased land) which must be paid by the new owner, but if the cost of land is included in the loan together with that of construction, it can be repaid on the same terms. There are a number of land-tenure systems which accommodate a gradual recovery of land cost as well as cost of trunk infrastructure. Sewer – and water charges are usually combined and paid through metered charges. On-site infrastructure can be lumped together with land and construction costs, and thus covered by the loan. In Kenya, fortunately, procedures for both zoning and registration of titles in urban areas are well established.

2. Tenure

Secure tenure need not be represented by a freehold title, but can take many other forms from leasehold to occupation certificates, as long as they are recognised by society, if not in law. The crucial aspect of tenure documents is that they are valid as a collateral for the loan to be granted by a public or private institution including community groups. There is a wealth of information on land tenure systems and

their relevance to finance. "Security of tenure" is often made out to be the panacea of low-income housing and economic development all together, whereas in most cases it is not, because local tradition and common practice have legitimised ownership of property and made it loanable, if not by formal financial institutions, then by Micro-credit and other less formal institutions, such as Credit Unions, Co-operatives, etc. which can obtain funding from the formal sector. An alternative to holding a registered title as collateral is to structure the finance arrangement as a "tenant purchase" contract i.e. the lender owns the house till the loan is paid off.

3. Planning

It is at the stage of land-use planning that the success or failure of a housing scheme is determined. The paramount issue is: How to assure that a scheme for the no/low-income groups does not become "a slum from the start" but continues to improve over time? Apart from physical planning which has developed rapidly in recent years, answers are further elaborated below. Typically, housing schemes for the poor are best planned in the areas where they already live. Thus, "squatter upgrading" and "slum improvement" schemes are IN. However, again typically, such projects require the removal of some housing units without an offer to the affected families of a better alternative at the same cost. These situations are highly criticisable and can spoil support for the project among those who were to benefit from it. This is often ignored by the implementing authorities because they feel that giving the affected families preference to the new units is a fair solution which, of course, it is not. The sequence of events is equally important. Existing shelters must not be destroyed before alternatives are provided. In a recent slum-upgrading project in Nairobi evicted families were offered a vacant site far from where they lived. As a result, they refused to move to this area.

4. Design

Closely linked to planning is the design of housing units, whether blocks of flats or individual houses are required. The objective, apart from keeping costs low, is the initial maximisation of privacy and the subsequent ease of conversion from a tenement to an integrated one-family unit. In addition, the design and layout of the scheme must safeguard against "over-development" both on the individual plot and on public spaces. These two requirements demand the best architects, engineers and perhaps even some economists and sociologists who can interpret the wishes of the occupants - both potential owners and tenants. In the scheme described above this was cleverly thought out to the satisfaction of all occupants by e.g. easy conversion of external doors to windows and preparing internal partitioning for new doors. "Over-development" can not be left to public building inspectors and must therefore be an integral part of the layout e.g. by not leaving space for it or, at least, preventing it from happening in front of the house. Environmental aspects, such as solar heating of water, internal or external water supply, solid waste removal, sewerage, etc. must all be optimised at the design phase.

5. Materials

Availability, suitability and cost of material are crucial to the success of a project. Absolute minimum or improvable standards must be allowed in order to reduce cost, if that is the optimal solution. However, cost cutting in the name of "affordability" is not nearly as relevant as establishing what potential owners are willing to pay for. In other words: If certain features e.g. solar heating of water though adding cost, have a high preference and can be included in the overall finance arrangement, new owners may be more than willing to pay. At least, they should be given a choice. The same goes for space for commercial activity e.g. an extra room facing the road. Any self-help inputs should be encouraged including employment of local residents on the project. Fortunately, a wealth of research

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and experimentation has been carried out and is available on this subject.⁵ Traditional as well as "state-of-the-arts" materials and techniques are widely documented and can be applied as appropriate. Wood and iron sheets are often shunned, but have worked well for centuries in many developed countries.

6. Finance

Financial arrangements are clearly the pivotal element of the argument in favour of housing for the very poor. Experience shows that poor people, particularly women, have good repayment records for housing loans. Still, much can be done to make repayment terms even more compatible with the borrowers ability to repay, e.g. through fixed interest loans by securitising these loans for sale to the secondary market. Alternatively, offer "fixed annuity" loans, or even better, "progressive annuity" loans which, by the virtue of increasing repayments of the principal, are much better suited to the income profile of poor families over time. This loan type also has the advantage of reaching families further down the income scale at the start of the lending operation. Various forms of incremental loans tied to progress in construction are also popular. In any case, there ought to be a choice of various loan types.

Computerisation has made calculations and bookkeeping of these loan instruments much easier. In fact, should a borrower come across extra funds he/she should be able to use them at any time to pay off part of the loan prematurely and thereby save on subsequent monthly payments. The lending institution simply prints out a new schedule with lower repayments but the same number of years to pay or a shorter term in case the borrower asks for it. Taking a leaf from the now famous Micro Credit Schemes can alleviate the problem of the required deposit. Because of the premium on low-cost space, an appropriate house, if properly built by contractors in an approved scheme is worth more than its cost as soon as it is habitable, thus making the deposit

superfluous for security reasons. The loan is presumably given to a viable project, which generates income i.e. the same principle used by commercial banks.

The advantage to the no-income group of not having to produce a deposit/down-payment in order to obtain an investment loan is so great that it is easily worth a premium interest rate ("affordability" vs. "willingness-to-pay"). It is not always politically correct to charge a higher rate of interest from poor borrowers than from "better-offs" but it should in any case be the borrower's choice. In Micro-finance organisations it is now acceptable to charge more for smaller than for larger loans. The added interest burden can be softened through progressive loan repayments, as mentioned above. Differentiating interest rates is important also from the lenders' point of view. Their urge to compete and innovate to accommodate all kinds of borrowers is enhanced by charging more for services with extra (perceived) risk and/or because small loans are costlier to process per unit lent.

CONCLUSIONS

The basic approach to housing the no-income group is to exploit the profit margins created for house owners by the very shelter shortage we are aiming to combat. The challenge is to put the various suggestions outlined in this brief presentation together in a specific project based on the concept of "letting" i.e. rooms for rent. When best practices from several schemes come together, the income-generating capacity of shelter can indeed be a solution to the housing problem of the no-income group. In short: If poor people can borrow funds to invest in a house with rooms to let, plus a room for themselves, they can pay off the loan from rental income. Keen observers will suggest that "if 6 rooms are adequate to house a no-income family, 12 rooms must be even more beneficial" True, but the number of house-owners would be smaller for the same amount of capital invested. Moreover, the

neighbourhood would change character, be difficult to manage and environmentally less attractive. Depending on local circumstances, 5- or 6- roomed houses may be optimal. Concerns that if the proposal is implemented on a large scale there will be a shortage of tenants is misplaced. There will always be families, poor and rich, who prefer to rent and the situation is anyway purely hypothetical

The critical issue is how to arrange finance for such schemes because it requires loans with an LTV ratio of 100 % on long term with repayment schedules compatible with the borrowers' income profile over time. Micro finance and other informal credit institutions do it, but mostly on shorter terms. Even commercial banks do it but at interest rates which cover higher unit cost of lending. How to select beneficiaries was not an issue in the BAT project since they were employees, but on a municipal or national level it is a problem which requires specific policy guidelines, but that issue is beyond the scope of this article.

Much more could be said to elucidate the concept as well as its practical implementation. However, the intention here is primarily to stimulate a discussion and to solicit comments and experiences on this vital topic. With respect to formal housing finance, the no-income group is by definition "defaulters before the event". But the old concept of "affordability" must give way to "accessibility" where poor borrowers will no longer be refused a housing loan on the basis of present income. Likewise, what lenders define as "affordable" should take into account of what borrowers are willing to pay, particularly if this is more than the orthodox 33% of income. Finally, should some in the no income group choose to sell their shelter privilege it has at least added to the housing stock and significantly alleviated their poverty.

⁵ F. Moavenzadeh "The Construction Industry" in Shelter, Settlement and Development Eds L..Rodwin (Allen & Unwin, Boston) 1987



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