POLAND

HOUSING FINANCE POLICY NOTE

March 19, 2006

This policy note is part of a World Bank targeted study on the prospects for development of the financial services industry in Poland. The study was requested and undertaken in cooperation with the National Bank of Poland (NBP). A World Bank team visited Poland in November 2004 and produced a draft note to stimulate discussion in Poland on some critical aspects of the housing finance system. The note was prepared by Loïc Chiquier, Leader of the Housing Finance Group in the World Bank, under the overall task of Marie-Renée Bakker (Finance/Private Sector Program Leader). The note was discussed at a workshop organized by the NBP on March 9-10, 2005 in Warsaw. This final version has benefited of comments made during and after the workshop, by Polish experts and peer reviewers representing both the private and public sector. It should be stressed that some of the most recent developments that have occurred in Poland within the last year may not be fully taken into account through this edited version. Support for the preparation of the note was provided by Mr. Jacek Laszek, Housing Finance Adviser at the NBP. The Bank Team would like to thank the NBP and all other parties involved for their effort and support in the preparation of this note.

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LIST OF ACRONYMS

ABS	Asset-backed Securities
AMRON	System for Analysis and Monitoring of Real Estate Market Transactions
APR	Annual Percentage Rate
ARM	Adjustable Rate Mortgage
BGK	Bank Gospodarstwa Krajowego
CPI	Consumer Price Index
DIM	Dual Index Mortgage
ECU	European Currency Unit
EU	European Union
FRM	Fixed Rate Mortgage
GDP	Gross Domestic Product
GINB	General Inspectorate (of Bank Supervision) of the NBP
IMF	International Monetary Fund
IUHF	International Union for Housing Finance
KFM	National Housing Fund
KNUiFE	Insurance and Pension Supervisory Agency
LTV	Loan-to-Value (ratio)
MBS	Mortgage-backed Securities
NBP	National Bank of Poland
OECD	Organization for Economic Cooperation and Development
PBA	Polish Banking Association
PLN	Polish Zloty
REIT	Real Estate Investment Trust
SPV	Special Purpose Vehicle
TBS	Non-profit (Housing) Associations
TC	Titularizadora Colombiana
UCITS	Undertakings of Collective Investment in Transferable Securities
VAT	Value Added Tax

EXECUTIVE SUMMARY

The **production of individual housing loans has been accelerating,** mostly through **universal banks** as a strategic part of their retail business. Yet, the mortgage portfolio is not as developed as in the older European Union (EU) member countries.

So far, this development has been sound, as the mortgage portfolio has been relatively well performing, competitive and remained largely unsubsidized. The main caveat if that the **model of specialized mortgage banks has not worked efficiently.**

Given the increased pace of the growth, better risk management, funding and regulatory tools are needed. The access of non specialized banks to bond markets through covered bonds and securitization is needed, with a **priority on covered bonds**, requiring further legal and regulatory adjustments. Linking mortgage and bond markets represents an opportunity to deepen Poland's financial system and diversifying the assets of institutional investors like pension funds. The **exposure to financial risks** of some banks could then be better managed.

New regulations are promptly needed to reduce the future **credit risk embedded in the prevailing hard-currency denominated mortgage loans**, through regulations upon lenders and specific consumer information.

Several **other lending regulations** (appraisal, capital adequacy, consumer information, etc.) would also deserve adjustments. The National Bank of Poland (NBP) needs to improve data about the banking system's mortgage portfolio. A mortgage insurance industry could be usefully introduced and regulated. Construction finance may not grow without further legal reforms.

The recent increase of housing prices in real terms coupled with the development of a sizeable program of mortgage credit subsidies leads to the recommendation that the Government should review some constraints affecting the **supply of land and housing markets**.

Rental residential markets need to be developed through several legal and regulatory reforms, as well as **a strategic re-assessment and realignment of the National Housing Fund**.

Some of these reforms could be accelerated by mobilizing technical assistance and projects from the World Bank and EU authorities.

I. EVOLUTION OF HOUSING LOANS

A. Increasing Individual Housing Loans

1. The Polish **housing stock** consists of 12.6 million units, for a population of 38.2 million inhabitants. The demography is stable but there are more urban households of a smaller size. Their increasing demand for housing is focused on dwellings that are larger in size and of better quality. According to a survey, 84% of dwellings are owned by individuals, either in full property or through cooperative membership rights.

2. As of August 2004, the outstanding debt **for individual housing loans** was estimated at **PLN 35 billion** by the National Bank of Poland ("NBP") or **4% of GDP**, many of the loans being secured by a mortgage lien. By the end of 2005, the data published by the industry through the Polish Banking Association (PBA) demonstrate a sustained growth of the housing lending industry, with an outstanding debt balance estimated at **PLN 52.3 billion (or 5.3% of the GDP), whereas NBP's statistics report PLN 50.6 billion,** out of which 59% are mortgaged.

3. The latest estimates by the NBP **on all residential loans** (not only to individuals) confirm the **steady growth of the housing lending industry**.

Housing credits (PLN Billion)	**2005**	**2004**	**2003**
Denominated in PLN	26.9	23.4	19.0
of which mortgaged	15.1	12.9	11.6
Denominated in foreign currency	32.3	20.5	20.7
of which mortgaged	18.8	12.3	12.2
Total	**59.2**	**44.0**	**39.1**
of which mortgaged	**34.0**	**25.2**	**23.8**

Source: NBP

4. The outstanding net balance of **all real estate loans** - adding construction finance, commercial property finance, non mortgaged housing loans and rental finance – was PLN **50.4 billion** by the end of 2004 according to the NBP, or 5.8% of GDP. By the end of 2005, this proportion has probably reached 7% of GDP.

5. This level of individual housing loans in Poland remains **lower** than the average in the 15 older EU members (45.7% of GDP by the end of 2004). Comparative studies across transition economies are difficult because data is neither reliable, nor compiled according to the same definition across countries. Yet by the end of 2004, **Poland ranked behind several other new EU members** (Hungary, Czech Republic, Baltic countries, Croatia -see the Table 1 below).On the other hand, Poland ranked higher than the other transition countries such as Slovenia. Romania, Bulgaria, and of course Russia, Ukraine, Kazakhstan. The accelerating trend observed in 2005 in suggests that Poland is catching up rapidly with the most advanced group of new EU countries, as far as the magnitude of its residential mortgage market is concerned.

Table 1: Balance of residential mortgage loans (end of the year, expressed as % GDP)

	2001	2002	2003	2004
Bulgaria	0.5%	0.7%	1.1%	2.6%
Croatia	5.8%	6.9%	8.8%	10.3%
Czech Republic	n/a	4.6%	6.1%	7.6%
Estonia	5.8%	7.9%	11.7%	16.6%
Hungary	2.3%	4.8%	7.9%	9.6%
Latvia	2.4%	4.2%	7.7%	11.5%
Lithuania	1.4%	2.3%	4.1%	7.0%
Poland	2.8%	3.5%	4.7%	5.5%
Romania	n/a	n/a	n.a	1.4%
Slovenia	0.4%	0.8%	1.2%	1.5%
Slovakia	n/a	4.0%	4.9%	6.1%
Turkey	0.2%	0.1%	0.2%	0.6%

Source: European Mortgage Federation (Hypostat)

Yet, the **growth of housing finance has been much faster than** the growth in general banking credit to the Polish economy. The nominal stock of housing debt has multiplied by 2.7 times in the last three years. The debt was only 1.2% of the GDP by the end of 1999[1] and this proportion has multiplied by a factor of 3.3 in five years.

6. According to the data compiled by the PBA (representing in 2004 88% of the individual housing loans extended by all banks), the net outstanding stock of individual housing loans increased by 61% in 2002, by 45% in 2003 (26% for all real estate loans), by 27% in 2004 and by 41% in 2005. About 40% of these housing loans are reported by banks to finance transactions in existing housing units.

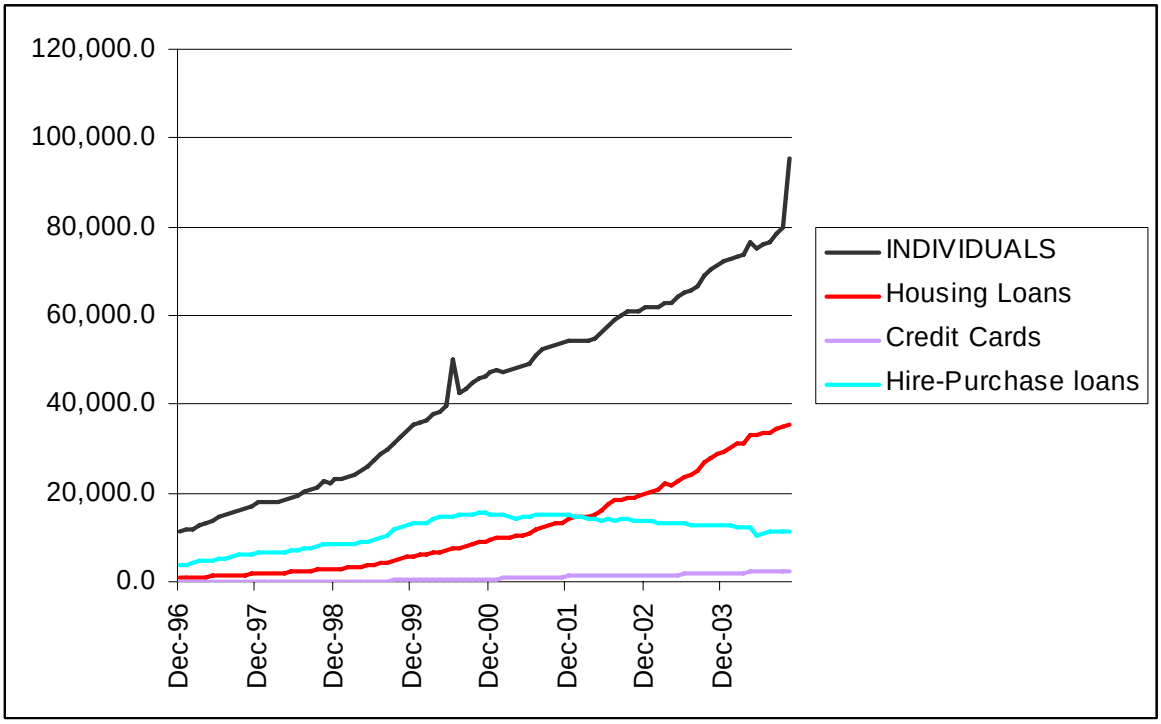
7. According to the same database, the **production of housing loans in 2003 was PLN 10.6 billion** representing about 128,000 loans. This represents an increase of 42% in amount and 26% in number of loans, when compared to 2002. The production is estimated to have increased again in 2004 by 33% with a production of PLN 14 billion. Initial information about the production in 2005 indicates a considerable increase 36% of the number of new housing loans (about 200,000).

8. The **proportion of hard currency denominated individual housing loans** - mostly in CHF, but also USD and Euro—in the loan production declined a bit in 2004 (**33%** of the total in 2004 versus 40% in 2003 according to the PBA), as PLN-denominated loans became more attractive with lower Wibor-based credit rates, thus facilitating the management of credit risk. But foreign exchange denominated housing loans have regained larger market acceptance during the year 2005, and the resulting share of hard-currency loans in the overall debt stock outstanding has increased to about **62%** (versus 59% by the end of November 2004, and 65% in December 2003). This **proportion is a growing matter of concern**, and further analysis and regulatory proposals are developed in Section IV-C of this Policy Note.

[1] International Housing Finance Sourcebook 2000, published by the IUHF.

9. **Lending for housing has been the key driver of the booming retail lending industry** in Poland (see Figure 1 below) and more generally of banking loan portfolio growth. Throughout the whole central European region, residential mortgages have become the most dynamic financial product. This is offsetting a slowdown or stagnation in corporate lending.

Figure 1. Domestic Bank Credit to Private Individuals by Type (PLN million)



Source: National Bank of Poland

10. Between 2002 and 2004, the share of individual housing loans within all loans to the private sector increased from 9% to **12%** (all real estate loans representing 22% of all loans to the private sector). At this pace, mortgage loans will represent about a quarter of all bank loans to the private sector in three or four years time. This could be a very positive element of stability and profitability for the banking sector, *as long as* the additional risks related to this expansion are well managed.

11. This evolution reflects **the growing demand** for better housing from households, the estimated creditworthy demand exceeding the actual housing needs[2]. This demand has been **leveraged by more affordable credit conditions** through lower market interest rates and longer loan terms, thanks to improved macroeconomic conditions and EU convergence (inflation below 2%, lower NBP base rates, and a recovering GDP growth rate), and the development of a retail banking industry (majority owned by foreign financial institutions) that is competing with mortgage finance as a relatively low-risk, cross-selling and attractive product.

[2] J. Laszek, NBP, 2004 "The development of the bank housing finance system for individuals in Poland".

12. On the one hand, the **number of loans** has increased by 36% in 2005, 13% in 2004 and 25% in 2003, reflecting the growing popularity of mortgage finance as a retail product. On the other hand, the **average size** of individual housing loans has also been increasing (**PLN 94,544** in 2004) by 14% in 2004 and 13% in 2003, which is significantly above inflation. The average loan size has further increased to **about PLN 111,000** during the first semester of 2005. This evolution reflects a significant change from times when housing loans were not larger than car loans, and is mainly explained by the steadily increasing housing prices in urban centers (observed on both new and existing housing units), and more attractive credit conditions through fiercely competing banks for households who may already bring much less down-payment.

13. The expanding mortgage market has facilitated the recovery of real estate markets **without creating any visible real estate bubble**. But it is now time to pay more attention to the housing and construction markets. During the last three years - from 31/12/2002 to 31/12/2005 - the CPI index accrued by 7.1%, whereas housing prices rose by 35.7% in the main six urban centers. **This appreciation** is equivalent to **8.2% in yearly real terms**, which is quite superior to the cost of mortgage debt. Several causes are involved including labor markets, incomes, investment markets but also the structure of land and housing markets. Two conclusions may be drawn: (i) the expansion of mortgage markets should continue, notably if boosted by new subsidies and further decline of market rates, and (ii) the government should work at **eliminating supply constraints** that may affect housing markets (land servicing, planning and permitting, developer competition and security, etc.) and at **developing rental residential markets**.

14. Although most banks compete through the use of housing loans, production remains **concentrated** at the top five national housing lenders[3] which account for 81% in 2002 and 85% in 2003 of total production. Despite gradual erosion, PKO BP (the former state savings bank, partly privatized in November 2004) remains the largest housing lender with about a one third market share. Yet, this relative market concentration has had no visible adverse effect on increased competition observed through declining mortgage credit rates and lower bank margins. But this situation enhances the need for stronger consumer information and protection in the housing finance area (see Section IV).

15. Given the likely persistence of these different factors, the Bank expects **this trend to continue in the coming years**. The growth in 2006 is expected to be as important as in 2005, because of the market anticipations of further increases of VAT rates on construction and/or building materials, thus fueling a particularly strong demand. The new Government program of housing credit subsidies through a sizeable interest buy down program should also fuel this growth for housing loans (see further Section on Affordability).

16. The main question for the Polish authorities is **whether both the soundness and accessibility of housing finance can be preserved at this pace, and how the expected growth of mortgage lending can be leveraged to deepen and broaden the Polish financial system,** including through tapping the capital markets as a source of longer term funding for housing finance lenders and a source of longer term investments for Polish institutional investors.

[3] Namely PKO BP, BPH Group, PKO SA, GE Mieszkanowy and Bank Zachodny WBK.

B. Stagnating Developers Finance

17. By the end of 2004, another **PLN 9.9 billion** represents the amount of commercial mortgage debt held by banks, both through short & medium term loans to developers (PLN 5-6 billion) and longer-term loans for standing investments of real estate investors. Institutional investors do not need to leverage debt, while **lending to developers has been stagnating** due to significant construction risks that have significantly exposed banks. A few banks remain active in that area through a necessarily very conservative credit policy that restricts eligible projects: best experienced developers, required titled land and permits, 20% of equity from developers (no reliance on the advances made by clients), special escrow accounts, bank's own on-site construction inspectors, etc.

18. The Association of Polish Banks points at the **issue of construction finance as a fundamental impediment to the broader development of housing finance** in Poland. A draft law has been prepared to protect the advances made by households to developers, through escrow accounts opened in banks against the case of a developer's bankruptcy. But the draft has been disputed and not passed yet. Completion and performance bonds could also help to reduce the risks associated with real estate development. The Bank cannot comment on the unknown details of the draft, but an improved legal framework is needed to unlock construction finance.

19. Another related aspect is the **capitalization of the housing developers**. This profession appears to be under-capitalized, which is an important stumbling block for any further expansion of the housing production. The Bank recommends further analysis: how many developers are listed on the Warsaw Stock Exchange or known to have tapped private equity sources? How is the quality of the accounting and financial statement information of real estate developers? Could REITs represent an equity funding vehicle for them?

20. Another constraint to the supply of affordable housing comes from the uncertainties, delays and costs related to all the permits required from various local government authorities to equip a land with the requisite infrastructure. The larger the housing finance system, the more inefficient these supply constraints may become if not remedied.

21. Because of these problems, the PBA, at the request of the association/chamber of real estate developers, had prepared the initial concept of a **Guarantee Fund** that may bear part of the credit risks (on mortgage borrowers and on developers). The part dedicated to construction finance as a way to increase the access to finance for developers is not recommended because of the difficulty for the state to measure and manage such risks. No international case may be called upon to support an equivalent proposal. Developer finance is an area reserved to professional lenders and investors, where any direct state involvement may unduly expose the government to construction risks, and moral hazard issues that may end up into undue subsidies. An alternative package of solutions may include legal reform of construction risk in order to protect the equity advances made by the households, facilitate land infrastructure and construction permits at the local level, and improve access to equity finance for developers.

II. AFFORDABILITY OF HOUSING LOANS

A. The Increasing Affordability of Housing Loans

22. The **affordability of market-based mortgage credits has significantly improved** in the past years. Maximum terms now reach 25-30 years (for an effective average maturity of 19 years by 2004, and a net average term of 14 years after prepayment). The loan-to-value ratios may reach 80%, and even 100% for clients that purchase additional credit insurance. As the level of inflation has gradually declined, the past production of Dual Index Mortgage loans was discontinued and replaced by a combination of hard-currency denominated loans and Wibor-based adjustable rate mortgages.

23. **Mortgage interest rates have declined to attractive levels** (7.5%-8.5% in PLN in 2004, and even lower observed credit interest rates below 7.5% in 2005) thanks to lower inflation rates, lower market base rates, and reduced margins charged by fiercely competing banks. Mortgage rates in 2004 were priced at 3-months Wibor+1.5%. Some banks even charged a lower fixed 5.5% rate, but only during the "teaser" first period year. The CHF-denominated housing loans have been priced around 5% in 2004, and also became even more attractive in 2005 through 3.75%-4% credit rates (sometimes lower 1.25%-2% "teaser" rates during the first year). The practice of commissions and fees follows no general pattern across banks.

24. A boosting factor upon the distribution of housing loans is the active and recent role played by dynamic **retail brokers** in placing mortgage loans. This evolution is fine but requires regulators to examine whether consumers are properly informed through these brokers, how this profession is self regulated – ex. how improper conducts are sanctioned - , whether clients are informed about broker fees in relation with the independence of the credit offers.

25. There is also **less cultural reluctance** towards mortgage loans, when compared with the situation several years ago, as such loans have gained popularity through marketing campaigns, more attractive conditions and a growing demand for housing. Media coverage has improved public education about housing loans[4]. Yet, more work is needed including possible regulations in order to better inform households about mortgage loans in a meaningful way, including information about all related risks and costs (see details in Sections IV-C and IV-D).

B. Housing Finance Subsidies

26. The residential loan portfolio has by and large **not been subsidized** since 1996, making its growth less vulnerable to any possible fiscal cut. This is a positive element of the Polish housing finance system when compared to Hungary or the Czech Republic. A new program of sizeable subsidies may be implemented soon.

[4] For example, the daily newspaper "Gazeta Wyborcza" is publishing useful studies rating that compare the quality of mortgage finance services across banks.

27. Two systems of **contractual housing savings and credit schemes** were created by law in 1997, but **never really implemented**, thus hopefully avoiding some of the problems of rent-seeking institutions and ineffective subsidies encountered in several other transition economies. One was a "Bausparkassen" model of specialized banks licensed to manage closed schemes of housing savings and loans at fixed low rates. State subsidies were to be granted through premiums on the savings. This model never took off and there are no such specialized institutions currently in operation, as premiums were reduced to a level where the profitability would have been insufficient. Another variant of contractual schemes was kick-started through a few commercial banks, with floating-rate contractual savings and credits, and fiscal support limited to tax deductibility of the interest paid on the savings. It was gradually abandoned as its attractiveness did not compare well to conventional market-based and variable-rate or indexed mortgage products.

28. Another form of state support was then introduced in 2003[5], by which the state would be paying for **interest rate subsidies** by converting 3-month Wibor variable rate loans into 6.5% fixed rate loans. A fund was created for that purpose and managed by the public bank BGK. The system was administratively complex, limited prepayments, and capped the banks' interest margin at 1.5%, which was found insufficient to compensate banks for their operating costs and risks. In addition to these problems, adjustable market rates declined, and banks have therefore not much used the system[6]. The World Bank advises terminating it.

29. In February 2006, the Ministry of Construction and Transportation announced **a new program of interest rate buy down for the PLN Wibor adjustable housing loans**. The initiative aims to reduce the expansion of risky foreign exchange loans. More than half of the credit rate would be paid back by the Government during the first eight years of the loan, which should be sufficient to help households during the most difficult repayment period until their incomes appreciate in nominal terms, and before Poland fully converts to the Euro zone (lower and stable market rates, no devaluation risk). The program is limited to new housing units and first time home owners. The subsidy is targeted through a maximum surface eligible (for the overall unit 75 or 100 M^2 and up to 50 M^2 for the corresponding part of the subsidized loan), and a maximum cost per M^2 periodically reviewed in each main urban center. Public expenditures will be significant (PLN 6.2 billion in the next 6 years) but would be gradually recouped through additional fiscal incomes related to the increased volume of housing construction and transactions. As the mission did not have a chance to thoroughly analyze the details of this program, it may reserve its further assessment, but share two preliminary observations: (i) the impact on market penetration should be positive, provided that the targeting is enforced through a modest maximum unit size, (ii) the Government should actively work at reducing the land and construction supply constraints, in order to make this program more efficient.

30. The 2002 budget law (article 26-b) has introduced **income tax deductibility of mortgage interest payments**. This measure could significantly discount the net interest cost of mortgage borrowing for households, notably those in the highest income tax brackets. But banks have not promoted this feature to commercialize mortgage loans because the actual impact is affected by

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[5] The law was published on December 5th 2002.

[6] Only about 200 loans since inception. The initial 2003 budgetary allocation of 30 million PLN has not been even fully used by now.

several associated conditions: (i) the principal amount may not exceed the value of a 70 M^2 apartment, (ii) it can be given only once during the lifetime of the household, and (iii) the beneficiary must not have enjoyed other housing subsidies[7].As these conditions remain contested in Poland, the Bank would like to stress that (i) where feasible, other governments have typically limited these regressive tax subsidies[8], and (ii) some of these conditions should become more accessible for the next generation of low-income households (less likely to have enjoyed other subsidies). On the other hand, any unlimited tax deductibility would distort markets and be very ineffective. Either these conditions may be dropped and the system simplified, in exchange for a socially acceptable cap on mortgage interest rate deductibility, or the tax exemptions may be plainly abandoned for new loans, given the more effective program of interest rate buy down.

31. The Ministry of Infrastructure has also mentioned its willingness to design a new system of **up-front housing vouchers** for targeted (low-income) households, as a form of down-payment support, separated from market-based mortgage finance. Such schemes should be carefully designed, targeted and monitored to avoid abuses or undue fiscal pressure. They may become unnecessary and/or redundant with the new program of interest buy down. The alternative option of supporting credit guarantee schemes may also be analyzed.

III. RISK MANAGEMENT AND REGULATIONS

A. Quality of the Mortgage Portfolio

32. The average **quality of bank housing loans** remains satisfactory, when compared to other loans to the private sector (which have an average 17.2% delinquency ratio). According to the NBP's General Inspectorate for Banking Supervision, 4.7% of housing loans are delinquent out of which 3.6% for individuals[9], and **3.1% have late payments above 3 months**. This latter indicator should be carefully watched as a possible area of concern, as the low rates of the variable-rate mortgage portfolio may further increase, and foreclosure remains untested.

33. In most countries, professional mortgage lenders pro-actively recover debt after 3 months of delinquent payments, notably as margins are not large in competitive markets. For example, the average proportion of delinquencies above 90 days for individual mortgages in the US is only 0.49%. The reasons of higher ratios observed in Poland should be studied by the NBP.

34. The level of net losses after **foreclosure** is unknown and cannot be accurately estimated without meaningful data[10]. The practice of unregistered statutory liens for public creditors has

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[7] Such as the former system of the deductible construction value from income taxes (abandoned since).

[8] Such has been the case for example in the UK, where the authorities have exploited a favorable cycle of declining market interest rates. By contrast, in the US, this subsidy will cost US$70 billion in 2005 (largest housing subsidy) and 78.5% is received by the 20% highest income group. The vested interest and strong lobby of US realtors and builders is blocking any needed reform.

[9] Classified as delinquent for individual private loans if more than 1 month late (sub-standard more than 3 months late, doubtful above 6 months, and loss above 12 months).

[10] For example, PKO BP is only recently capable to track the details of its national portfolio through an improved information system.

been hopefully revisited, but interviewed banks report the foreclosure process to be still generally long, untested or hazardous. More information is needed in that area.

35. The court system's land and mortgage books are being gradually modernized (electronic database implemented in 6 pilot offices by the end of 2004, 66 were expected to be completed by the end of 2005), thus reducing costs and delays, and enhancing the collateral security of mortgage lenders.

36. The **NBP must increase its capacity to monitor the banking system's mortgage portfolio performance**, as the data it currently assembles are not sufficient to properly monitor the activity and propose meaningful regulatory reforms. More data should be compiled on the mortgage portfolio, such as loan-to-value (LTV) ratios, the purpose of real estate loans (not just the legal or private personality of the borrower), debt-to-income ratios, the age and residual term of the loans, the credit rate and applied adjustment index, the presence of a mortgage lien, etc. Some new reporting forms from banks are expected to be implemented by the NBP during the first semester of 2005, but the mission did not have the opportunity to update this information.

37. Another **positive initiative** sponsored and launched by private banks - also promoted by the NBP—is the creation in September 2004 of "**AMRON"**[11]**—**a new and accessible database of actual housing transactions. **AMRON** should improve the capacity of lenders, insurers and investors in mortgage securities to manage credit risk, facilitate the appraisal process and the development of risk modeling, and produce useful indices of housing prices for both the public and private sector. Several banks do now participate in the project. The Bank hopes that more participants will include the community of real estate professionals (realtors and appraisers).

38. Banks must keep improving comprehensive and high-quality risk management systems, in order to manage both their related financial and credit risks. So far, few banks appear to have developed credit scoring systems capable to discriminate credit applications and price risks.

B. Development of Mortgage Insurance Products

39. The Bank encourages the authorities to **complete a study on the opportunity and feasibility of introducing a mortgage credit insurance industry** for lenders, and the concomitant need for limited state support and/or public-private partnership.

40. Mortgage insurance would cover a substantial part of the mortgage debt due to lenders in cases of a borrower's default, thus improving the accessibility of lower-income households to housing finance through lower down-payment, helping banks to re-allocate their credit risk and promoting prudential lending standards. Banks would also be subject to reduced regulatory capital adequacy requirements and loan loss provisions. The product could provide credit enhancement to covered bonds[12] and mortgage-backed securities.

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[11] Polish acronym for "System for Analysis and Monitoring of Real Estate Market Transactions".

[12] The eligible cover assets could exceed the current 60% LTV threshold if the difference was well covered at first loss by an external credit insurance program.

41. But this insurance activity also requires improved risk management tools and specific regulations for insurers including sufficient capital reserves against systemic risks. Some contacted international private insurers have expressed their operational concern on the difficulties faced by lenders in enforcing mortgage foreclosure in Poland.

42. The Government may envisage supporting such products to promote social housing (by direct capitalization, or by co-payment of the actuarial premium) and develop forms of private-public partnerships that may also be explored by the study.

43. Some private insurance companies such as "TU Europa" already commercialize two close variants of mortgage insurance products:

a. short-term bridge of the collateral risk for the lender until a property title is created and mortgaged and,

b. sale to the borrower of a default guarantee to pay for his credit as long as the LTV exceeds 80% (5 or 10 year long insurance, expensively priced between 3.25% and 7.25% as a flat up-front fee, or 1% as a spread payable over 5 years).

44. The regulatory framework for these existing insurance products is not known to the Bank. The proposed study should build upon these early experiences.

C. The Issue of Hard-Currency Denominated Mortgage Loans

45. The NBP has expressed several times its legitimate concern about the prevailing production of **hard-currency** denominated long-term mortgage loans, which represented 59% of the overall mortgage debt by September 2004. The proportion has even reached **62%** by the end of 2005. These loans represented the major part of the new housing lending in 2005. They are popular because of their yield differential observed through the nominal credit rates (more than 3%) versus PLN loans. This factor is appealing to households who got accustomed in average in the past years to a strong Zloty (appreciating in nominal terms against the USD) and are often not aware of the longer term credit risk embedded through such loans.

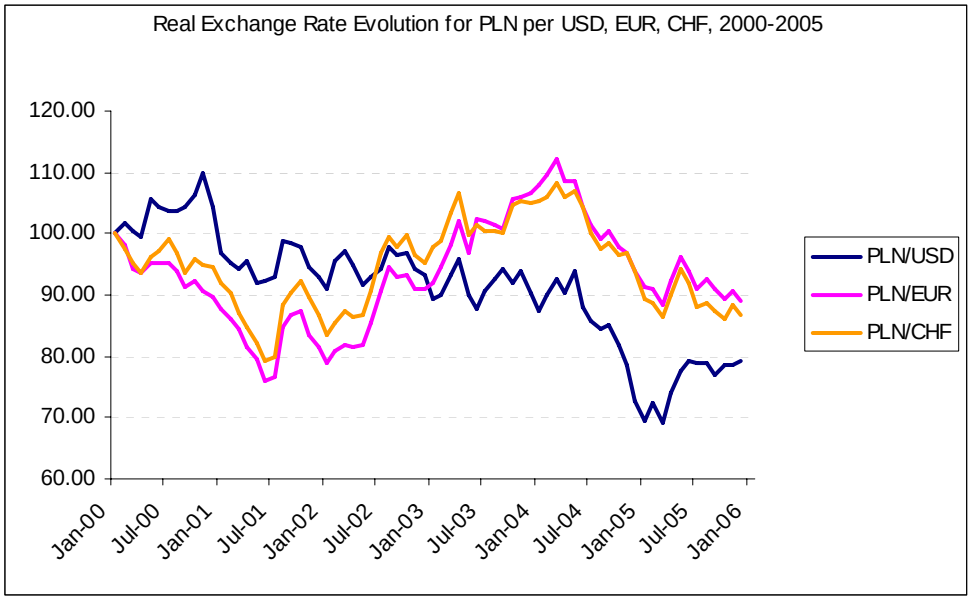
46. For a limited period between 2003 and 2004, the trend was reversed as more clients opted for PLN housing loans, due the result of the depreciation of the PLN against the Euro during the year 2003 and the subsequent revaluation of their mortgage repayments. The proportion of CHF-denominated loans has been increasing particularly rapidly since (already 40% of PKO BP's portfolio) because the CHF presents the lowest nominal interest rates.

47. A less visible reality of this type of lending is that some significant foreign exchange risk is transferred to households through the indexed mortgage debt balance and repayments, thus increasing the potential credit risk for the lending bank in case of a creeping or sudden devaluation. The risk is often even accentuated by the variable rate nature of these Libor-based contracts. High-income borrowers with sufficient alternative savings and/or hedged incomes may more easily absorb any shock than lower-income borrowers.

48. Some banks have accordingly tightened their underwriting policy and adjusted their legal contracts[13]. But there was no banking regulation, nor consumer information rule that deals with this serious issue given the longevity of the housing loans versus foreign exchange rate fluctuations. Banks look more driven by commercial considerations than prudential risk management. More attention should be paid towards more vulnerable groups as mortgage markets expand. One bank declared that it may have to revert in 2005 its former decision not to lend hard currency mortgage loans, in order to preserve its eroding market share and avoid a refinancing run of its borrowers.

49. So far, the past evolution of the PLN versus the Euro and the Swiss Franc is not too worrying when analyzed in real terms in the long term, although relatively large short-term fluctuations have been observed through a 6-year cycle (Figure 2). As with most other world currencies, more uncertainty and risk remains attached to the USD denominated mortgage contracts given the strong real appreciation of the PLN vis-à-vis the Dollar.

Figure 2. Real Exchange Rate Evolution for PLN, 2000-2005



Source: Bank Staff estimations based on nominal exchange rates and CPI published by the IMF.

50. In the long run, international experience does not report favorable outcomes on foreign currency mortgage loans that can represent reasonable transition instruments during a period of macro-economic recovery, but also triggered a mortgage crisis in Argentina, and created problems in Italy with a pilot experience of ECU-denominated mortgage loans.

51. This risk also cannot be easily estimated through a published comparative effective interest rate. So **relevant consumer information** may have to include other tools of

[13] Borrowers recognizing having been informed and consenting about the indexation.

transparency and education, such as for example providing on a mandatory base to prospective clients a simulated amortization table according to one common devaluation case (as periodically published just as a worse case scenario by the NBP or the MOF). The mission could observe that several banks legally bypass the difficulty through a credit contract including an article whereby the borrower plainly acknowledges having been duly informed, but this is clearly insufficient.

52. Banks should be required to demonstrate how their credit underwriting and pricing policy has been adjusted in order to cope with the devaluation impact on credit risks (through stress tests, adjusted scoring instruments). As a result, some banks should be assigned specific lending limits and/or additional capital requirements (or general loan-loss provisioning depending on whether this additional risk is considered as exceptional or cyclical). **Further regulatory measures are expected very soon by the NBP Banking Supervision Commission,** in order to prevent banks from making too many of such loans. The drastic option of a unilateral ban has been rejected as hostile to the needed market competition and consumer's free choice.

D. Other Issues on Consumer Information

53. Broader questions on consumer information and protection arise as the range of mortgage loan products is rapidly diversifying through competition and innovation. For example many different Wibor indexes are applied to PLN loans, many credit offers promote a low "teaser" rate during an initial period, prepayment fees vary from one lender to another, as do application and upfront origination fees. More consistency and transparency is needed for the sake of consumers.

54. There should be no mandatory counseling but some pressure for transparency and the possibility for households to compare credit offers, including rates and fees. Part of the problem is that there is no related EU Directive in force yet for mortgage residential finance.

55. **Mortgage finance has been so far quite a self-regulated area within the EU zone**, mainly through a voluntary Code of Conduct that emerged from a discussion process between consumer and housing lender industry organizations. The participatory lenders provide standardized pre-contractual information through the European Single Information Sheet (ESIS). This latter is a concise and simple tool, which covers key points like the Annual Percentage Rate (**APR**) and prepayment fee. The Commission recognized the Code's existence by way of a Recommendation, but the Code remains by large ineffective as long as it has no enforcement capacity. The Commission is examining further regulations including consumer information for the harmonization of European mortgage markets through a White Paper, to be published in 2006. The Bank recommends Polish authorities to investigate about the chances of a related EC regulation within the next months, and in the likely case of delays, not to defer any longer the implementation of key disposals. Similar steps have been taken by few other member countries.

E. Appraisal Norms and Capital Adequacy Rules

56. The Banking Supervision Commission has adopted the Resolution No. 4/2004 dated as of 8th September 2004, which reserves the lower **50% risk-weighting ratio** - for capital adequacy purposes of banks - for residential mortgage loans with a LTV lower than 50%, as determined

through a full appraisal report by a mandated and licensed appraiser. In order to justify for this demanding conditions, the NBP has been pointing at some unfavorable **realities of Polish real estate markets**, including the lack of reliable data, the low quality of appraisers, the lack of experience of real estate intermediaries, the unclear legal status of some properties, and the operational difficulty and delays to foreclose for the banks through the judiciary system notably when no substitute housing solution is provided to the defaulting household.

57. Basel principles do permit each national regulator to appreciate such elements of market infrastructure within each country, before granting any lower risk weighting for the residential mortgage loans (down to 35% for residential mortgage loans through the standardized approach, cf Basel II Directives and EC Capital Requirement Directives).

58. The 50% LTV threshold set up is seen by Polish lenders as conservative in relation to the appreciation of housing prices in the major urban centers, the preliminary findings on non-performing loans and post-foreclosure losses, and international best practices. But on the other hand, it is up to the banking community to demonstrate to their regulators that residential mortgage loans are secure below a higher LTV ceiling (for example 60%) and that foreclosure may proceed reasonably well despite some incurred costs and delays.

59. The most important issue of the regulation may relate to th**e unduly conservative and unaffordable appraisal requirement,** when applied to loans for single homes (as opposed to larger loans for commercial property buildings), given the required level of detail and costs of a full appraisal in Poland (between PLN 500 and 800, and to be renewed every year: these significant costs would eventually have to be paid by households). The rule also unfairly disqualifies in-house bank appraisers, even when kept at bay from the credit decision process.

60. The Polish Foundation for Mortgage Credits made a counter-proposal that consists of applying to all commercial banks the conservative principle of the "mortgage lending value" so far applied only to the mortgage banks that issue mortgage bonds. This method is simpler and cheaper than a full mandated appraisal, but also produces lower lending values than market values, which turns away many potential lower-income clients by requiring them to eventually add more equity. The method also unreasonably assumes that real estate appraisers may perform sector risk studies in order to eliminate factors of market speculation; this has rarely been observed when bubbles were forming both in developed and emerging markets.

61. Under such circumstances, some banks declared that they will *not* solicit the proposed 50% risk-weighting ratio from the NBP (some can still afford it given their large capitalization) because of burdensome and costly consequences. If the appraisal rule not adjusted, the regulation may reduce the competitiveness and affordability of mortgage finance in Poland. The Bank recommends that the NBP simplify this appraisal requirement (simpler form of market-value appraisal for single housing transactions, by licensed appraisers not participating in the credit decision process). The tougher form of appraisal including periodic reassessments would better fit the case of a lower risk-weighting (50%) for commercial property mortgage loans.

IV. ACCESSING BOND MARKETS

A. An Opportunity to Reduce Cash-Flow Risks

62. **The banking system's mortgage portfolio is funded by shorter-term deposits,** still through quite liquid commercial banks. But at the current pace of growth of mortgage lending, some of these banks may soon need to mobilize longer-term funds, given their increasing exposure to **liquidity risk** that results from a rapidly accruing long-term mortgage portfolio and a shrinking base of shorter-term household deposits. This effect is also due to the increased attractiveness of alternative saving products offered by non-bank institutions such as mutual funds.

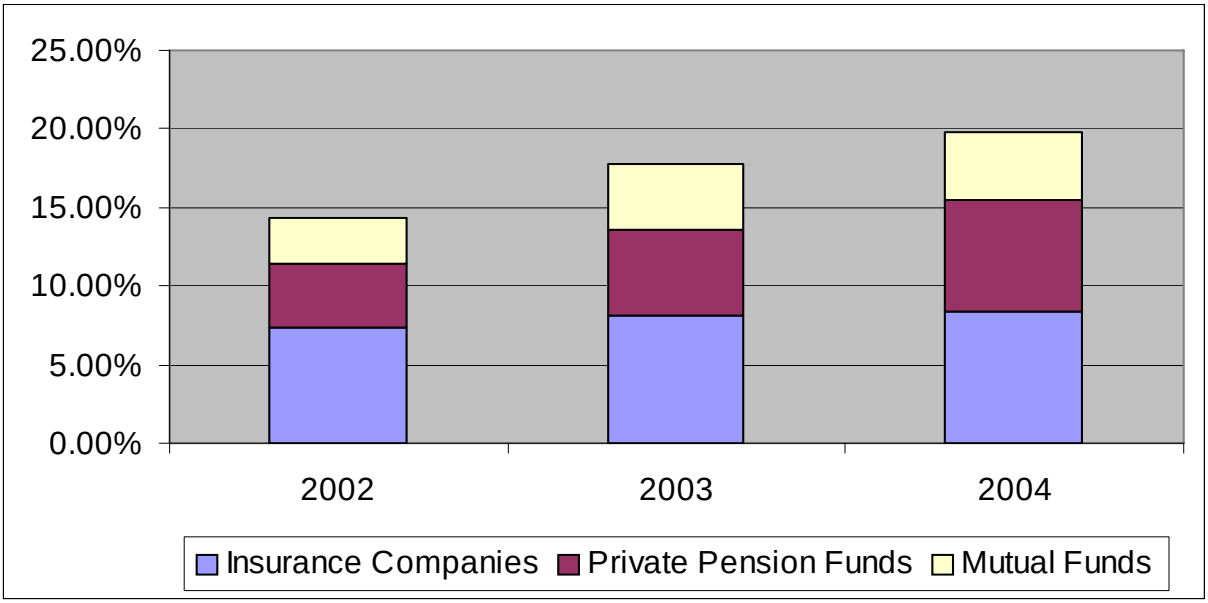
63. The **proportion of long-term housing loans to household deposits has increased from 9.2% in 2002 to 16.7% by mid 2004**. This level may still not be worrying in the aggregate, but (i) some individual banks may have already reached a substantially higher level of transformation, and (ii) if the observed trend continues, the ratio may reach an excessive level within 2 or 3 years time. There is no given international standard for the housing loan-to-deposit ratio, as it notably depends on the stability of core deposits in any given banking system subject to various internal and external factors. But a rough estimate for a sustainable ceiling in Poland would be between 30% and 40%.

64. **Commercial banks should gradually diversify their funding base by accessing domestic bond markets**, both though **mortgage/covered bonds and securitization**. This will require several reforms, as detailed in the following sections. In the short run, well-capitalized banks may have more incentives to issue mortgage **covered bonds** (cheaper, simpler) than to securitize their profitable and low-risk mortgage assets.

65. The timing for this reform appears opportune as **non-bank institutional investors** have been growing rapidly (see Figure 3). The total assets of insurance companies, private pension funds and mutual funds rose from 14.3% of the GDP in 2002 to **19.8% of GDP** by the end of 2004[14]. This magnitude represents a great opportunity for expanding residential mortgage markets (limited at 4% of GDP and mostly deposit funded). Only a modest portion of the surplus would be sufficient to finance a sustainable development of the Polish housing finance system.

[14] Respectively 7.1% of GDP for private pension funds, 4.3% of GDP for mutual/investment funds, and 8.4% of GDP for insurance companies.

Figure 3. Net Assets of Non-Bank Institutional Investors in Poland (% of GDP)



Source: KNUiFE, Polish Securities Commission

66. Currently, these **institutional investors cannot optimally diversify their investments,** even though they must honor their long-term liabilities (as is the case for private pension funds and life insurance companies), because of the severely under-developed stage of the domestic private bond markets. The **development of sizeable low-risk mortgage securities would represent an opportunity for institutional investors** who may be expected to buy well-rated longer dated mortgage securities, notably for private pension funds and life insurance companies.

67. The expected limited liquidity of nascent mortgage securities markets should not impose excessive premiums on the issuers, as institutional investors seem willing to buy and hold these papers as long as the risk-adjusted yield satisfies them, provided that regulatory measures do not force them otherwise. Yet, a sizeable development of the mortgage bond market may require less crowding out by public sector bonds and a longer yield curve than the 5-year limit observed by the end of 2004.

68. The pressure to access bond markets may increase if the NBP's Banking Supervision Commission drafts new regulations for banks addressing their increasing exposure to the growing mismatch between long-term mortgage assets and short-term deposits.

69. The exposure of banks to **market risk** is less significant, as housing loans are variable rate and priced according to their funding base (either hard currency denominated, or Wibor indexed).

70. As market conditions and the yield curve keep improving, **fixed rate mortgages** ("FRMs") may appear. This would reduce credit risk and stabilize repayments when compared to the prevailing adjustable rate or indexed loans. But this evolution may force lenders to blend

their deposit funding with mortgage securities, in order to re-allocate part of the additional interest rate risk.

71. This evolution towards FRMs may become **commercially feasible** when the observed interest rate gap (estimated at 2% between FRMs that may be priced at 10%[15] and Adjustable Rate Mortgages ("ARMs") at 8%) could be narrower[16] and/or after a period of rising Wibor rates.

72. **Prepayment risk** will have to be managed, either through the issued mortgage securities, and/or through the margin and prepayment fees applied to the borrowers.

B. Mortgage Banks and Mortgage Bonds

73. The **specialized mortgage banks** - 4 of them being licensed –had **an insignificant market share** by the end of 2004 (5% of real estate loans, but less than 2% of individual housing loans). By that time, they had also issued few mortgage bonds (the equivalent of Euro 221 million, for an outstanding balance of Euro 208 million). The proceeds of these bonds were mostly used to finance commercial property activities rather than housing individual loans.

74. The size of most issued mortgage bonds has been small, as if tailored to the needs of private placements, and denominated in various currencies (PLN, Euro, and USD). Public offerings were in the minority. Most bonds were issued by Rheinhyp-BRE Mortgage Bank at floating rates. The usual term was 5-year. The obtained spread has been declining to a level (49 basis points) in line with BBB/A3 rating conditions, as the familiarity of investors with this type of paper is growing along with their appetite for PLN-denominated private bonds.

75. The legal framework for mortgage bonds in Poland generally appears to meet the common definition of these instruments in Europe, as included through the European UCITS Directive (article 22-24)[17], and subsequently used through other directives (investment of insurance companies into mortgage bonds, eligibility of mortgage bonds as Tier-1 assets for the ECB). This statement is independent whether Poland may comply or not with the other requirements related to this Directive that regulates the investment of collective investment schemes into securities. It is perceived by the mission that insurance companies and investment funds could be authorized to acquire more of these bonds. But the question of investment limits is far from being urgent, as long as the mortgage bond market remains so small.

76. Each mortgage bank has been following its own strategy, sometimes abandoning residential mortgage finance, or on the contrary focusing on such activities, or competing for the

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[15] Estimation, based on the latest pricing of 5-year Treasury bonds at 7%.

[16] A premature attempt was undertaken in 2000 by Deutsche Bank which offered 15.75% FRMs from 5 to 25 years with a steep 10% prepayment fee. These conditions were financially justified but not attractive.

[17] The correct name of this Directive is "Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCTIS) 85/611/EEC".

distribution of mortgage loans with its own parent bank, which may offer more attractive credit conditions. The specialized mortgage banks have found it very difficult to compete for individual mortgage loans against larger commercial banks that have a larger network of branches, cheaper deposit funding, and profitable cross-selling opportunities.

77. Part of the multiple development problems encountered by these specialized banks therefore results from the evolution of the overall banking system, but it is also of the opinion of the Mission that these difficulties were exacerbated by an **improper and rigid legal framework for the issuance of mortgage bonds only though specialized banks**.

78. The mortgage banks are subject to more rigid rules than commercial banks in order to conduct their housing credit operations:

a. tighter appraisal rules using a conservative "mortgage lending value";
b. limited amount of unsecured debt equal to 6 times the equity of the bank;
c. ineligible loans to housing cooperative members;
d. less than 30% of the portfolio with a LTV ratio exceeding 60%;
e. requirement to complete registration of all mortgage liens before issuing the bond;
f. obstacles to construction finance (requirement for a notarized request of a mortgage lien application, which is not possible until the property title is itself created).

79. The **Mortgage Banks and Mortgage Bonds Act** (dated as of 1997, already amended once in September 2002) needs to be amended again in order to both **facilitate access for universal banks to mortgage bonds, and introduce operational flexibility to mortgage banks**, while preserving the quality of mortgage bonds. There is an interesting opportunity that results from the convergence of a rapidly growing mortgage portfolio in commercial banks exposed to more liquidity risks, and the diversification investment needs of non-bank institutional investors.

80. Commercial banks should be encouraged to diversify the funding of their mortgage loans through **long-term covered mortgage bonds**, without having to rely only on complex securitization. Most countries now let their banks chose according to their respective financial situations and cost effectiveness considerations between covered bonds (on balance sheet funding) or securitization (off balance sheet). If both options require further legislative work in Poland, the mission would recommend starting with **an easier access for commercial banks to covered mortgage bonds**.

81. One way to expand the use of covered bonds—as now possible in Germany, Ireland, UK, etc. always been used in Czech Republic or Chile now on a large scale, or more recently introduced in Romania, Turkey—consists of **licensing universal banks to issue covered bonds** under stringent conditions in order to protect the expected cash-flow of the bond investors, (including improved matching principles when compared to the current Act). This approach is probably the most efficient in Poland, provided that banks would also be assigned a reasonable issuance ceiling, so that not to undermine their subordinated creditors and depositors.

82. An alternative way may be considered from the variant introduced in Hungary. It would preserve the principle of specialized mortgage banks but would permit an indirect access for the universal banks to covered bond funding, by having the specialized mortgage bank(s) refinance universal banks through the purchase of their mortgage liens as cover assets, while the mortgage loans would remain on the balance sheet of the partner commercial banks along with the credit risk and most of the margin. Another variant would see a facilitated sale of the mortgage loans (exempted of taxes & fees) so as to create a private liquidity facility acting as a centralized mortgage bank (as in Switzerland) to tap bond markets on behalf of multiple banks. The solution of any **centralized issuer** of cover bonds would have to be carefully designed, so that to preserve its fully private and specialized mandate from any other policy priority and state involvement.

83. **A study may be commissioned to compare the merits and pitfalls of these options in Poland**, while capturing the best practices observed in many member countries which have recently improved or created some corresponding legislations. The World Bank Group may provide further detailed recommendations and/or suggest the names of worldwide experts, if Polish authorities agree on the importance to pursue such work.

C. An Incomplete Legal and Regulatory Framework for Securitization

84. The Investment Fund Law was amended (as published on June 28, 2004) in order to create new **securitization funds**, which function as special-purpose-vehicles (SPVs - both bankruptcy-remote and tax neutral) and issue special securitization certificates (both asset-backed securities (ABS) and mortgage-backed securities (MBS)). Another proposed route through the revised banking law consists of letting banks create their own SPVs in order to issue MBS.

85. Most banks support the development of structured finance but also express limited interest in securitizing their mortgage loans in the short run, given their high level of capitalization, the positive impact of profitable mortgage loans kept on balance-sheet, the under-developed stage of market infrastructure needed for MBS and the high related transaction costs (credit standards, scoring and credit enhancement tools, seasoned performance, tested foreclosure, monitored data, information system, etc.).

86. But in addition, several **important legal and regulatory deficiencies** have also been identified by the Bank, and need to be remedied before securitization can become operational in the medium run. This is not only true for MBS, but also for ABS, which are likely to emerge faster in Polish markets (consumer loans, car loans, credit card receivables).

87. Remedying these deficiencies will require intensive and **concerted efforts**, and more joint preparatory work by public financial authorities and the private sector (banks, institutional investors, rating agencies, bond dealers, lawyers, tax experts, etc.). The sooner this process may start, the better in terms of getting a functional funding route. But given the Polish financial market realities, the authorities should be reminded that MBS may not anyway become for long the main attractive funding instrument of residential mortgage markets, notably when compared to covered bonds, if these latter could be made more easily accessible to the commercial banks.

88. Polish lenders that sell their loans to securitization funds are currently prohibited from holding any related certificates, including subordinated tranches. Thus, banks cannot provide internal credit enhancement for their MBS in this convenient way, which is all the more of a problem given that there is still no external insurance product for the credit risk in mortgage loan pools. Lenders also have less incentive to service their loans in the most effective way if they are not directly exposed to credit risks. This situation should be negatively assessed by external rating agencies and would ultimately enhance the costs of funds through higher yields paid to investors. The laudable purpose of perfecting the conditions of a true sale may have misguided the legislator to this counter-productive measure.

89. Securitization funds are to be managed by joint stock companies that cannot be capitalized by the selling banks, even through minority participations. This absolute firewall will not permit banks to establish their own funding tool, which may create a serious disincentive for the development of this funding model.

90. A successful counter-example may be found in Colombia through a securitization company "Titularizadora Colombiana" (TC) which has been capitalized by private primary banks that lend for mortgages. In less than 4 years, TC has already securitized a quarter of all existing mortgage loans, including non-performing ones. It has considerably reduced the exposure to market and liquidity risks of banks and permitted them to extend and diversify their lending. Its securities have grown in popularity through all types of institutional investors, as reflected through lower spreads. The Government has also developed a complete legal and regulatory framework for the issued securities and securitization companies.

91. In Poland, the management companies of securitization funds are authorized to invest in their own certificates, including subordinated tranches that concentrate risks. Their embedded interest as investors may as a result conflict with their main fiduciary SPV responsibilities towards other investors. If functioning as secondary mortgage companies like in Colombia, their activities should go beyond a simple SPV role, and may not only be subject to market discipline, but also to prudential regulations and supervision, including capital requirements (as is the case in most other countries).

92. The explicit consent of borrowers to allow the sale of their mortgage loans to third parties is a requirement that can be perfected only for new contracts (special clause). The requirement does not apply to existing housing loans originated before 2004. Anyway, this is not a major problem as other technical factors prevent the securitization of mortgage loans before a couple of years at best.

93. It will be more difficult to securitize mortgage loans than other assets, as MBS certificates may not be issued until the transfer of each mortgage lien is registered (costs, uncompressible delays). In other similar laws/jurisdictions, this requirement is lifted or facilitated, as complex and expensive synthetic transactions are otherwise required.

94. According to article 92-b of the revised banking law, banks may alternatively decide to securitize their receivables through a SPV joint-stock company, whose activities are restricted to

acquiring receivables and issuing securities. The selling bank will not be authorized to interact with the SPV, and conditions of true sale are also perfected (banks are not allowed to buy back their own receivables in most cases). Banks are also prevented from holding any of the securities backed by their own receivables (see the article 81).

95. This attempt to create a trust within a civil code legal system may add flexibility, but can only be practically usable when several loopholes are closed: (i) tax neutrality of the SPV, (ii) facilitated transfer of the assets and liens, (iii) explicit mention of segregated assets in case of the bank's bankruptcy, (iii) detailed rights and duties of the SPV company (capital, debt borrowing and bond issuance, enhancement support, regulations, etc.), (iv) adjustment of the status of such corporate bonds to the specifics of structured finance and differentiated repayment rights, and (v) possible acquisition of the issued securities by the selling bank, etc.

96. Despite the novelty and complexity of securitization for investors, there is no required external rating for public issues, whichever the legal framework for securitization. This situation does not facilitate the assignment of different risk-weighting ratios by the NBP to the various classes of ABS/MBS securities to be held by banks. The revised standardized approach recommended by Basel II critically differentiates these ratios according to the bonds' risk-adjusted external ratings. The regulatory regime of capital adequacy for banks uniformly treats securitization certificates as bonds (100% risk-weighted as corporate bonds) and disregards the actual exposure to risks according to the nature of the securitized assets[18] and the risk allocation built into the structured finance transaction. This may not permit the development of MBS.

97. The NBP also proposes to fully deduct capital for the subordinated papers held by banks (equivalent to a 1250% risk weighting). This rule is an over-simplification and would sometimes excessively increase enhancement costs. Such a high risk weight is typically applied only to the subordinated certificates held by the same bank that sold the loans (forbidden in Poland), or to non-rated or badly rated papers. The Bank would recommend following Basel II principles, in particular the revised standardized approach on securitization.

98. Whichever the legal framework for securitization, bond disclosure rules set by the Polish Securities Commission do not yet capture the cash flow and risk specifics of securitization certificates. More information would be needed by investors both at issuance and periodically on the pool of securitized assets – e.g., their performance, prepayments, collateral, distribution of risks, quality of servicing, credit enhancement solutions - than on the management company that issued the paper.

99. Whatever the legal route, more regulatory work is also needed to (i) set up accounting rules adjusted to value the options embedded in these papers and the possibility that illiquid secondary markets reveal no fair market value (no significant trading if investors just buy and hold), and (ii) disclose haircuts to make MBS eligible for use in repo markets.

[18] Most residential mortgage loans before securitization should be 50% risk-weighted.

V. RENTAL FINANCE

A. Under-Developed Rental Markets

100. Most interlocutors stressed the under-developed and under-financed stage of the private rental sector in Poland. Developing rental markets continue to be one of the priorities of the Ministry of Transport and Construction to cater to the needs of younger, mobile, and vulnerable households who have not already benefited from subsidized housing programs and privatization[19] A vibrant rental market is needed to increase the responsiveness and dynamism of housing markets - also enhancing the soundness of mortgage markets - and to increase labor mobility.

101. The Bank recommends conducting a **study that analyzes and compares rental yields** - net of costs, risks and taxes - of alternative capital placements available to private individual and institutional investors. Much debated laws such as the **Tenant Protection Act** have probably defeated their main purpose of increasing affordable rental solutions for tenants, by discouraging private landlords to invest in formal rental markets. By contrast, informal leasing arrangements are reported to dramatically increase rent levels without due tenure security of informal tenants.

102. The Parliament introduced in 2005 a contested second generation of rent controls for administratively allocated flats in private rental buildings, by limiting the yearly rental increase to 10%, regardless of the current rent level. Another discouraging factor is the difficulty in getting the judiciary system to sanction eviction of defaulting tenants considered as exposed to social vulnerability (Civil Code).

103. An additional negative factor is the **unfavorable tax regime** for social rental investors when compared to new homeowners (which may enjoy deductible mortgage interest under specific conditions) since an experimental system of tax credits for landlords was abandoned in 2003. The latter facilitated the construction and leasing of 40,000 flats, but reported numerous abuses by developers and investors mainly interested in obtaining de facto highly subsidized ownership of apartments disguised as rentals. Further reforms are deemed necessary to boost genuine private and affordable rental markets that can be sustainable through fair tax treatment, but without distorting supply-side subsidies.

B. Assessment of the National Housing Fund

104. The **National Housing Fund (KFM)** is a **public rental program** that has financed since its inception in 1996 completion of 61,573 occupied new rental units for moderate income tenants (an additional 11,758 dwellings are currently under construction). The program has been steadily growing in size, with production in 2004 staying at 9,100 dwellings, but in 2005 declined to 8,000 dwellings.(actual figures are: 1997 – 417; 1998 – 1,627; 1999 – 5,048; 2000 – 8,441; 2001 – 11,755; 2002 – 6,617; 2003 – 10,597; 2004 – 9,091; 2005 – 7,956) The program

[19] The tenants of municipal flats and the buyers of privatized housing units sold at discounted prices.

has commitments till 2009 at the level of over PLN 2.1 billion (including pending disbursements on existing contracts, approved credits in this year – also for infrastructure). Very little of these commitments is under construction – since most remains at the pre-construction stage.

105. The Fund is directly administered by the state bank BGK through long-term credits extended to non-profit landlord TBS organizations. The repayment performance of this subsidized long-term portfolio was until 2004 excellent, partly because of subsidized credit rates.

106. The main operators and borrowers are **non-profit associations ("TBS")** championed by municipalities, and some rental cooperatives and sometimes even private developers (in total about 450 institutions by the end of 2004). The applied rents must cover the credit repayment and all maintenance and renovation costs, and should not exceed 4% of the replacement investment value. The KFM also finances infrastructure loans directly to municipalities, but this activity is still relatively marginal in size.

107. The program does not target particularly low income tenants. The KFM does not control the declared incomes, as this responsibility is delegated to the TBS and the sponsoring municipality according to its own local housing policy, but anecdotal evidence suggests little follow-up monitoring and evaluation.

108. A rigorous assessment of the large subsidies (through below-market interest rates) is needed, as some subsidies may be inefficient and regressively allocated, when put in perspective with the evolution of private rental markets and mortgage markets.

109. The rental associations or cooperatives are required to provide 30% equity, the Fund financing up to 70% of the project. This down payment may derive from the tenants, who as a result consider themselves as quasi owners and are selected through this qualification. This situation may end up running against targeting goals[20] and create problems for housing allocations.[21]

110. This experience is unique in transition economies. The KFM was designed at a time of high market interest rates, a depressed construction cycle, and a moribund public rental sector. After seven years of operations and important changes in the economy and housing markets, the program deserves an **in-depth strategic re-assessment and realignment** of its objectives, products, conditions, governance and funding. One should also undertake comparison with other countries and their instruments for achieving similar goals, notably through the EU region.

111. The Fund is currently managed directly by the BGK as one of its public missions. No fee or margin is applied (but the bank's treasury may commercially invest the budgetary allocations before disbursement). The BGK produces separate accounts for the KFM, but the Fund is consolidated within the BGK. The Bank recommends **improving the governance of the KFM** by creating its own Board made up of a mixed panel of professionals, responsible for assessing its performance and suggesting needed reforms to the Government.

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[20] Households that provide a large down-payment may not receive subsidies through low rents funded by subsidized credits.

[21] Many of these households will not become legal owners when their incomes increase.

112. **The funding of the KFM depends excessively on budgetary grants** from the national housing budget (PLN 450 million in 2003, 473 million in 2004, and 165 million in 2005). As repayment inflows from the long-term loans are marginal, any expansion is affected by planned budgetary cuts as happened visibly in 2005. However, the proposal for 2006 has been made at PLN 353 million in order not to dramatically downsize it. Out of PLN5.3 billion of credits disbursed by the KFM (actually 4.1 billion for TBS, 1.2 billion for cooperative rentals, and 0.1 billion for infrastructure), **about PLN 3.2 billion or 60% has been funded by Government budget grants**. The rest was mainly funded by long-term public debt contracted after 2002 from two multilateral institutions[22] in order to keep expanding the program.

113. **This vulnerability would be reduced if KFM loans were less subsidized.** A 3.5% interest rate is applied to the KFM's dual-index mortgage loans ("DIMs"). The debt interest rate is adjusted quarterly to half of the NBP base rate[23], whereas repayments are indexed quarterly to the official cost of construction (in case of no rise in construction costs index it is still raised by 0.3%). Through this mechanism, the first monthly installment is kept at a very low level (0.35% of the loan amount[24]) in order to gain as much as possible on affordability and reduce the level of rental repayments. This corresponds to an expected maturity of 35 years, although best practice recommends keeping the expected maturity of DIMs within 20 years.[25]

114. This implies an interest rate subsidy in Net Present Value terms in excess of **60%** of the loan amount, notwithstanding the inherent risk of any unpaid residual debt balance. As mentioned before, the **targeting of these subsidies has become questionable, notably as the fiscal pressure is more intense, and as some other housing programs require as well significant public funding, such as the new system of mortgage credit interest buy down.**

115. **Narrowing the gap with market conditions seems increasingly needed for the next generation of KFM loans that would not target lower-income tenants.** Co-financing and refinancing with commercial banks, as well as issuing domestic bonds should be considered to relieve the pressure of budgetary funding. In order to bridge its funding needs, the KFM is currently considering refinancing by selling its current portfolio for a 20 year period to mortgage banks, and paying for the interest rate differential with the requested market rate including a margin for the purchasing banks.[26] The cost of funds of this expensive option should be compared to the BGK issuing its own bonds, as a state bank.

116. Other initiatives, ongoing and contemplated should be reviewed as additional measures in order to broaden the spectrum of rental housing supply, including **alternative forms of public and private partnerships.** One such initiative is the currently debated concept of privately produced rental housing made available to municipalities, as jointly promoted by the Polish Banking Association, and developers through their trade organization (PZBD). The

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[22] Namely the European Investment Bank and the European Council Development Bank. The Government has extended its sovereign guarantee for these loans, priced the foreign exchange risk, and provided cofinancing.

[23] The applied credit being the maximum between 3.5%, and half of the adjustable NBP rediscount rate.

[24] This level used to be ranged between 0.30% and 0.38%. The minimum has been increased not long ago.

[25] Otherwise, an unfavorable evolution of the indexes would lead through the indexation mechanism to an over-stretched term and a non-amortized debt balance, resulting in further long-term losses for the KFM.

[26] At variable rate market conditions (110% of the 52 week Treasury Bill interest rate + 1%).

municipalities that are unable and/or uninterested in building their own new social rental housing, would partner up with developers and bankers responsible for producing these new residential dwellings, subject to pre-arranged long-term leases with municipalities, backed possibly by some guarantees giving comfort that leased rents will be paid (by municipalities). Municipalities would also most likely facilitate this process by providing well planned and serviced building lots for these construction projects. At expiration of the leases the buildings would become municipal property.

117. The concept is at an early stage of discussions, although some municipalities seem willing to experiment. The PBA has expressed interest in having dialogue with the Bank to gain better view on international experience with similar concepts, as well as have the Bank evaluate the proposed concept and implementation schemes. The initiative may help to broaden the spectrum of rental housing solutions by including market driven production of social housing that would complement budget funded support to municipalities.

118. The Bank recommends also that a third pillar be considered for policy initiative – the market based rental housing, which requires a number of facilitating regulations putting it at the level playing field with homeownership production. This would allow the Government to develop a comprehensive rental housing policy for promotion of housing choice and labor mobility in three rental sub-sectors: market-based, non-profit, and social/municipal.

VI. NEXT STEPS

119. Since the fruitful **policy workshop** held by the NBP in March 9-10, 2005, the mission has received several useful feedback comments, many have been incorporated through this revised version. The mission would like to warmly thank the numerous contributors.

120. **Further technical assistance** and project funding (loans and grants) may be solicited by the Government of Poland and the NBP from the World Bank, in order to support the expansion of housing finance markets in a sustainable and affordable way. Further discussions could be held to prioritize the areas of further cooperation among those presented in this policy note.

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LIST OF MEETINGS

Agnieszka Drewicz - Tułodziecka Magdalena Mikołajczyk	Fundacja na Rzecz Kredytu Hipotecznego
Andrzej Reich	NBP/GINB
Bolesław Meluch Zbigniew Krysiak	ZBP – Komitet ds. Finansowania Nieruchomości
Dyr. Anna Wydrzyńska Z-ca Dyr. Jarosław Czosnyka	Bank BPH Departament Finansowania Nieruchomości
Dyr. Bartosz Drabikowski Adam Jankowski – Naczelnik Wydziału Prawnego	Ministerstwo Finansów, Departament Instytucji Finansowych
Dyr. J. Osiński	NBP DSF – podsumowanie
Dyr. Jolanta Bondarczuk Dyr. Elżbieta Kudawska-Bulwarska Dyr. Janusz Szatoba Dyr. Jerzy Dzierżyński	BGK Krajowy Fundusz Mieszkaniowy
Dyr. Justyna Galbarczyk	PKO BP Pion Finansowania Nieruchomości
Dyr. Marek Zawiślak	Ministerstwo Infrastruktury Departament Finansowania Mieszkalnictwa
Dyr. Sprzedaży Tadeusz Hołyński	Towarzystwo Ubezp. EUROPA - odwołane
Dyr. Tomasz Zyśko	PEKAO S.A. Wydział bankowości detalicznej, Departament produktów kredytowych
Jacek Łaszek	NBP
Jolanta Zombirt	NBP
Krzysztof Kanigowski	NBP/GINB
Prezes Irena Stocka	HypoVereinsbank Bank Hipoteczny
Prezes Lech Gajewski	Nykredit Polska
Prezes Mariusz Karpiński	GE Bank Mieszkaniowy – odwołane
Prezes Piotr Cyburt Dyr. Krzysztof Czerkas − Dep. Zarządzania Ryzykiem Kredytowym Dyr. Paweł Łopuszyński – Dep. Skarbu	Rheinhyp BRE
Prof. Marek Bryx Kierownik Katedry	Katedra Inwestycji i Nieruchomości SGH (tylko LC, bez obecności DK)
Wiceprzew. Zbigniew Mrowiec	KPWiG, Z-ca Przewodniczącego d.s. Prawnych