FINANCIAL FRAMEWORK

A. Public and private investment

Public investment in housing at the national as well as at the local level practically has ceased in recent years. At the same time the private sector was not yet capable of taking over the role as the primary source of investment. As shown in table 5.1, there was no investment of the public sector and only minor investment by the private sector in 2003 and 2004 in terms of apartments put in place. Of total dwelling space put in place (328,000 m^2 in 2003 and 2004), the share of State enterprises and organizations was zero, while 100 per cent was put in place by individual builders. Average floor area shows that new construction is primarily targeted towards the luxury segment of the market. Only a tiny fraction of investments went to rural areas.[41]

Particularly at the local government level, where the main responsibilities for the implementation of housing policies are located, financial and human resources are very tight and often sufficient only for performing basic administrative duties. The law on the *Local Budget*, however, attempts to simplify the allocation of money from the State budget to the municipal budget by providing a procedure by which the local budget is designed locally. This is of crucial importance, as local government has access to the sufficient financial resources of its own to actually exercise these responsibilities.

Previously, local governments were able to collect revenue from property tax, although they owned no land. In accordance with the law on *Payable, Non-Payable, and Capital incomes and their Distribution Among the Territorial Divisions of Georgia* of 2004, property and gaming tax is paid to local government, along with a share of personal income and profit tax, as well as non-taxable income raised in a particular municipality. Under the *Organic Law,* local governments will have the ownership of land within their boundaries transferred to them from the central Government. However, no obligation has, been placed on local government to use income generated from sales of land for housing purposes. As an example of current practice, in Tbilisi it is the assembly of the local government that decides at what price land is to be sold at auction; this does not have to be based on the nominal price but can be based on the market price. The money raised through that land sale is transferred to the local budget, but it is not earmarked for housing purposes. In Tbilisi, revenues from land sale currently account for approximately 10 per cent of the budget.

A further drawback is the fact that there is currently no system of cadastral evaluation. Land tax is calculated in accordance with zoning regulations, i.e. different multiples of the normative value set by the municipal government. The municipal government establishes a normative value for land. This is multiplied in accordance with the zone of the city the land is situated.

In general, tax revenues both at the national and at the local level increased significantly in recent years, thus enhancing the scope for housing activities. Within the central budget, revenues more than tripled between 2001 and 2005 (from 631 million to 1.836 billion lari), and grew by 44 per cent within local budgets (from 324 to 575 million lari).

B. Mortgages and banking market

The mortgage sector only started to develop in the last four years and is experiencing strong growth today.[42] Leading banks provide mortgage loans at nominal interest rates of

[41] MED. Department of Statistics. Statistical Yearbook 2005, p. 231.

[42] Statistics on the total amount of mortgages are not available, as banks do not differentiate mortgages from other credits in their balance sheets; however, it is estimated that approximately 60 per cent of banks' total credit portfolio is secured by real estate (Georgia Enterprise Growth Initiative, p. 2). There is also a lack of statistics on construction and land development loans.

Table 5.1. **Number and average floor area of apartments put in place by the public and private sectors**

Years	Public sector		Private sector	
	Number of apartments (in 1,000)	Average floor area of one apartment, m^2	Number of apartments (in 1,000)	Average floor area of one apartment, m^2
1995	0.4	76	0.8	160
1996	0.4	81	0.7	157
1997	0.1	101	0.6	144
1998	0.2	112	0.6	125
1999	0.2	83	0.9	194
2000	0.2	152	1.2	166
2001	-	-	0.7	201
2002	0.2	95	0.9	163
2003	-	-	1.1	211
2004	-	-	0.7	194

between 13 and 20 per cent[43] and offer an increasingly differentiated product range. Longer maturities (10 years and even more) become available. Major banks offering mortgages are TBC Bank, Bank of Georgia and ProCredit Bank. Bank of Georgia's mortgage portfolio, for instance, increased by 137 per cent in 2005.

Previously, agreements between households and construction companies were common in which households made a down payment and were allowed to pay off the purchase price through installments at no interest. However, these agreements had maximal maturities of 18-24 months and finished when the purchaser moved in. Moreover, they were perceived to be very risky, as there is anecdotic evidence of fraud, so that the development of the formal mortgage market is clearly preferable.

In practical terms, with regards to the provision of a secure title for creditors financing construction at the beginning of the construction process, there is a separate title to the land against which the construction company takes a corporate loan (the future apartment owners make an unsecured down payment before the title is registered although a contract is registered with the construction company that is notarized).

When the foundation is laid then the building is registered as under construction and the title is registered in the name of the future apartment owners, i.e. a building under construction can be registered in the Real Estate Registry upon the construction of the foundation with this title being offered as collateral by the "future" homeowners to the bank. This system appears to being working in practice, although loans are only extended to construction companies and homeowners whose income provides the bank with security.

Affordability of mortgage loans remains limited, as real interest rates are relatively high, and as a minimum salary of around $400 is

43 Average consumer price inflation for the period 2003-2005 was 6.2 per cent. See Economist Intelligence Unit. Country Report, Georgia 2006, p. 5.

required to apply for a mortgage loan with most banks. The threshold varies according to the number of family members who are dependent on the given income and who could participate in covering the loan.

Prices for a one-room flat of 25 m^2 in the centre of Tbilisi have risen to $30,000-45,000 in the last few years, starting from less than $10,000 in the year 2000. The reasons for this increase are initial low prices, strong demand from Georgians living abroad, higher prices for imported building materials, and the speculative attraction of the real estate sector due to its expected growth potential.

The price for an equal apartment in the suburbs is now $15,000-20,000. Table 5.2 shows the calculation of monthly installments for selected loan amounts and interest rates. Obviously, only a small percentage of the population can afford such transactions.

The practice of over-collateralization – with banks taking in the double or even triple loan amount as collateral – is about to cease. Average loan-to-value ratios are reported to be between 60 and 80 per cent in most cases. Application procedures are still quite bureaucratic and vary widely among banks. Documentation requirements often include proofs of stable income, visits at the borrower's workplace and a recommendation by his/her supervisor.

Table 5.2. **Monthly installments (in $ for a maturity of 10 years)**

Interest rate / Loan amount	14.5%	16 %	18 %
$10,000	158	167	180
$15,000	237	251	270
$25,000	396	419	450
$30,000	475	503	541
$45,000	712	754	811

Source: TBC Bank

Although the mortgage segment of the financial market is expanding rapidly, a number legal concerns limit further development. A crucial problem is that foreclosure reportedly may take up to several years in practice, especially when court decisions are involved. The main issues of concern are related to the Civil Law and were carefully identified in a project conducted by the Georgia Enterprise Growth Initiative (GEGI). Amendments to these provisions stand to make loan repayment and the sale of foreclosed property more flexible, consequently removing barriers to mortgage lending. Some legal limitations are summarized in the following.[44]

1. According to the *Civil Code* (art. 303), *if the debtor resides alone or with a family in the building or in the part of the building which is encumbered with a mortgage, then he is entitled to stay therein as a tenant (after foreclosure sale) and is obliged to pay rent at the market rate to the acquirer of the property*. Thus, if the collateral of a loan issued by a lender is an apartment, it becomes virtually impossible to remove the resident(s) from the building. Therefore, through the first court hearing, the lender has to obtain the right to sell the mortgaged apartment through an auction which requires a minimum of one year under the current procedural legislation. Afterwards, the lender has to deal with the tenant based on a rental agreement. If the tenant violates the conditions of the rental agreement or if the lender has sound reasons that may become a basis for revoking the rental agreement, a new court case has to be initiated. Then after the passage of one more year, it may be possible to remove the tenants from the apartment. These problems can be resolved through modification of the mentioned article or through its elimination from *Civil Code*.

2. According to the *Civil Code* (art. 278), *the foreclosure shall be executed through the sale of the collateral at auction*. At the moment, only the courts are entitled to hold an auction. Existing legislation does not provide for holding auctions without a court decision. For this reason, lenders have to apply to the courts with the plea. Such pleas, as a rule, are

[44] For a detailed compilation of provisions in the Civil Code, the Civil Procedures Code and the Law on Commercial Banks, see Georgia Enterprise Growth Initiative. Survey of Mortgage Lenders on Lending Problems. 2005.

generally appealed by the debtor in most instances. This is a lengthy procedure, and in most cases the property undergoes physical depreciation, and the proceeds obtained through its sales often fail to cover the principal and interest amount. Therefore, it would be expedient if the law specifies the auctioning mechanism or enables lenders to sell property without auctioning.

3. According to the Civil Procedures Code, *the courts shall examine the civil cases not later than two months following the day of filing the application*. For especially complicated cases, this term may be extended for not more than five months. Existing practice shows that courts exercise their rights to the maximum capacity. If courts of all instances, (regional, district and Supreme) apply this right to examine the case after five months following the day of application filling, the case may be completed after 15 months and only after this term the lengthy process of execution begins. Therefore, it is advisable to reduce the term between filling the application and examining the civil cases by courts.

Resolution of these issues and amendments to the relevant laws will address the problems of each lender on the financial market. These problems are common for all financial institutions and therefore, their settlement is critical.

Furthermore, it is important to note that no certified real estate appraisal system exists in Georgia. This could define and facilitate valuation and inspection procedures and strengthen the basis of the mortgage sector and the real estate market as a whole. Currently, the value of land is deliberately undervalued when it is mortgaged, a practice that continues unhindered in the absence of a law on Valuation.

With respect to land and real estate registration, this is governed by the amended *Civil Code* and the 2006 *Law on State Registration*, which provides that ownership rights are recognized only if registered. Only registered rights can be officially sold, leased, or used as collateral. Although the amended *Civil Code* imposes an obligation to register a transfer of real estate in the real estate registry, its introduction represents step back in terms of establishing a complete public registry of titles. Under the first edition of the *Civil Code,* transactions were annulled if they were not registered within three months; under the new *Civil Code,* fines are simply imposed.

The new *Law on State Registration* (passed in March 2006 and entered into force in June 2006) promises to remove some of the problems experienced due to the provisions of the old *Law on State Registration* of 1996. In the 1996 law, if a technical mistake had been made during the registration process, the registration could only be amended by a court decision. In the new law the mistake can be rectified by simply notifying the owner.

The problem remains, however, of people paying for purchase after signing the agreement at the notary office, thereby creating the possibility of dual registration. To deal with this problem, the validity of an extract from the cadastre has been reduced from one month to 10 days. This does not erase the possibility of two notarized agreements coexisting thus suggesting the need for a centralized database for notaries.

Banking sector

The Ministry of Finance and the National Bank, as supervisory authorities, are attempting to develop the banking market as a whole.[45] Almost 99 per cent of the financial intermediation in Georgia is done through the banking system, whereas securities markets play a marginal role.

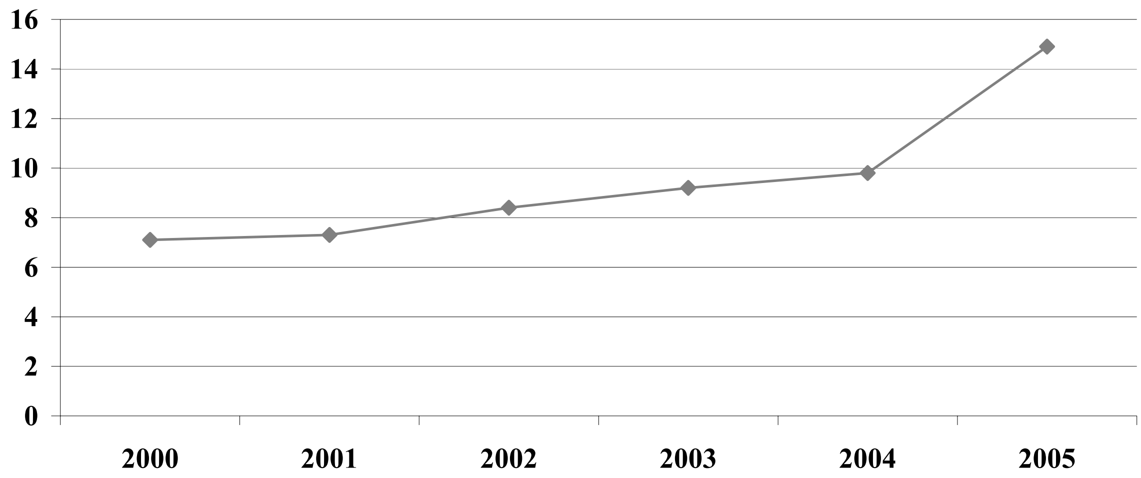
After independence, the transformation of the banking system started: a two-tiered universal banking system was established, with the National Bank of Georgia (NBG) as the regulating authority (*Organic Law on the National Bank of Georgia*, 1995) and a network of commercial banks originating from the privatization of State banks.

However, banking legislation was imperfect and licensing requirements for commercial banks too weak (e.g. the minimal statutory capital to establish a bank in 1994 was approximately $500). As a result, the number of banking institutions increased from five in 1991 to

[45] National Bank of Georgia. Georgian Banking System Development Strategy for 2006-09.

226 in 1994, most of them facing financial difficulties. Confidence in the banking sector vanished, and the volume of deposits dropped to almost zero. From 1995-1996 onwards, the National Bank of Georgia in cooperation with international institutions, tightened banking regulation and licensing (chapter II of *Law on Activities of Commercial Banks*, 1996) and reduced the number of commercial banks by 173 up to 1997. From then on, banking activities experienced strong growth. Gross assets of the banking sector as of December 2005 accounted to 2.54 billion lari (a growth of 50 % during 2005). Credits grew by 85 per cent in the same period, and the ratio of loans to GDP more than doubled between 2000 and 2005 (figure 5.1).

Figure 5.1. **Ratio of loans against GDP (%), 2000-2005**



The dollarization of loans is decreasing significantly, and the participation of foreign financial institutions reached a level of around 50 per cent of capital of resident commercial banks owned by foreign institutions as of 31 December 2005. Concentration in the banking sector is high, with a group of six large banks holding 87 per cent of total assets of the banking system. The banking sector is fairly profitable, with an average Return on Equity of 14.9 per cent. During 2005, deposits attracted grew by 31 per cent, reflecting a resumption of confidence. Two Georgian banks have been awarded credit rating B by Fitch (the country was awarded a long-term sovereign credit rating of B+ – with a positive trend – in December 2005).

Long-term refinancing facilities, however, especially from local sources, are limited. In 2004, TBC Bank had total liabilities of 331 million lari, of which 86 per cent consisted of current accounts and time deposits owed to customers[46], thus constraining the ability for long-term lending. For ProCredit Bank, 93 per cent of total liabilities showed maturities of less than 12 months in 2005.[47]

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[46] TBC Bank. Annual Report 2004, p. 74.
[47] ProCredit Bank. Annual Report 2005, p. 55.