

## V. FINANCIAL FRAMEWORK

This chapter starts with an overview of the role of the housing sector in the national economy, which is followed by a more detailed, three-dimensional description of the current situation in Romania. The three dimensions are the three main financial forces shaping the housing sector: the affordability of housing (**sect. B**), public spending (**sect. C**) and private lending (**sect. D**). In other words, this part describes the context of housing finance from the perspective of the private household, the public sector and the corporate (banking) sector. The final section is devoted to a short account of how current financing conditions affect the “reality” of the housing sector.

### A. Housing and the national economy

In 1998 the construction sector contributed 5.3% to gross domestic product. In the same year the value of construction work for residential buildings (under contract, including maintenance and current repairs) amounted to 2,899 billion lei - 8.8% of the total value of contract construction work (see **table 14**). Investment in construction hovered around 40% of total investment between 1993 and 1997, reaching 44.5% in 1998 (US\$1.7 billion). In 1999 investments were financed mostly out of the developer's own (56%) or non-banking sources (22.9%). Bank credits contributed 11.2% to investment financing, while subsidies and State and local budgets accounted for 9.9% of investment funds<sup>17</sup>

**Table 14. Construction work under contract by category of object, 1998 (million lei, current prices)**

Category of object	Value of construction work
Total	32,950,245
Residential buildings, of which:	2,898,788
Single household	1,837,273
Multi-household	1,061,515

Source: National Commission for Statistics, Romanian Statistical Yearbook 1999 (electronic version).

The share of housing investment in gross national product is small, far below EU levels and generally lower than that in other central European countries (see **table 15**). This reflects the low housing output, although it should be noted that a significant share of new housing construction is believed to be unauthorized and, therefore, not statistically registered (estimated at around 20% of the total)<sup>18</sup>.

<sup>17</sup> Country Note – Romania, Organisation for Economic Co-operation and Development (document prepared for Workshop on Housing Finance in Transition Economies, held in Paris, June 2000).

<sup>18</sup> Ibidem.

**Table 15. Housing investment as a percentage of GDP in 1995, 1997 and 1998**

Country	1995	1997	1998
Czech Republic	0.7	1.4	1.5
France	4.6	4.8	4.5
Lithuania	0.7	0.5	0.6
Netherlands	4.8	4.8	4.6
Poland	0.5	1.0	1.1
Slovakia	2.5	2.9	3.5
Romania	0.9	n/a	0.8

Source: Calculation based on National Commission of Statistics data and Bulletin of Housing and Building Statistics for Europe and North America, United Nations 2000.

During the 1990s, the public sector's share of the construction industry diminished. In 1993 construction work by publicly owned companies accounted for 64.3%, against 30.2% by private enterprises. In 1998 the picture was quite the reverse, with the private sector accounting for 74.7%<sup>19</sup>.

In the aftermath of the 1989 revolution, there was a decline in public investment in housing, as the State ceased its direct support of housing construction. The public sector's share in housing investment is now far smaller than that of the private sector, a tendency illustrated by the break-down into the main financing sources of completed dwellings (see **tables 16 and 17**). If unauthorized construction output were taken into account, the proportion would be even more in favour of private investors.

**Table 16. Authorized housing construction by main financing source, 1991-98 (number of dwellings)**

	1991	1995	1997	1998
Total	27,958	35,822	29,921	29,692
of which:				
Public funds	21,520	8,970	3,494	2,915
private funds	6438	26744	26149	26550
of which:				
Households	6,498	26,583	25,878	26,298
Private companies	0	161	271	252

Source: Country Note – Romania, prepared for Workshop on Housing Finance in Transition Economies held in Paris, June 2000, Organisation for Economic Co-operation and Development.

**Table 17. Authorized housing construction by main financing source, 2000 (first quarter)**

	Completed dwellings (number)			Structure (%)	
	Q I 2000	Q I 1999	QI 2000 - QI 1999	Q I 2000	Q I 1999
Total	2,701	2,127	+574	100.0	100.0
of which:					
public subsidies	105	60	+45	3.9	2.8
private funds	2,524	2,019	+505	93.4	94.9
of which:					
Households	2,524	1,987	+537	93.4	93.4

Source: National Commission of Statistics, Press Release No. 28/2000.

<sup>19</sup> Calculation based on Romanian Statistical Yearbook 1999 (electronic version), National Commission for Statistics.

The above trend reflects not so much the rise of the private sector, but rather the very limited involvement of public authorities in housing construction, on both national and local levels. The municipalities, which are by law responsible for providing housing, are not to be blamed for this, however, since the necessary resources have not accompanied the new responsibilities.

The role of the housing sector in the national economy could also be appreciated by analysing consumption figures in the national accounts. To this end, estimates of:

- The consumption of housing services (in monetary terms, as rents, or as imputed rents in owner-occupied dwellings), and
- The consumption of utilities by households (electricity, gas, etc.)

could help to judge the weight of the housing sector in the Romanian economy. However, detailed analysis of that kind would make sense only if comparable international data were readily available, which is not the case. For the purpose of this report, then, it can only be concluded that, while Romania has a substantial housing stock for the size of the country (see chapter II), the volume of housing-related consumption seems very limited. It would certainly need to be adjusted for the generally poor quality of the stock; and the very restricted access to utilities - especially in rural areas, where almost half the housing stock is situated - also drags down the consumption figures.

### **B. Factors affecting demand for housing**

Investment in housing is largely a function of demand. The demand for housing is often identified with the housing deficit, i.e. the number of housing units necessary for all the households in a country. However, this kind of demand should be considered as potential demand and, in a market economy, the category of potential demand has a very limited use. This is particularly the case where the public sector is not normally expected (or in a position) to provide the supply of housing sufficient to meet this demand. So in cases such as Romania, housing investment will be a function of actual (effective) demand from the households which are able to enter the market. Nonetheless, the impact of government policies on the size of this demand should not be underestimated. It can vary considerably among countries and over time; but it should always be considered as an important factor affecting housing investment. Of course, the public authorities can still be a direct supplier of housing in the market and so affect investment volumes.

Housing deficit numbers are not very helpful. While in quantitative terms it is clear that Romanian society is not heavily under-housed today, prospects for the future are debatable. Demographic projections show that the Romanian population will shrink considerably over the next decades. On the other hand, average household size will probably diminish due to the ageing of the population and the change in social patterns. Bearing in mind that part of the existing stock will have to be demolished and that new construction output is low, the situation is very likely to change in future years.

The situation is much clearer with qualitative deficits. The survey data show that the density of housing is the most important problem for the public<sup>20</sup>. Another driving force for new housing demand in Romania – though less evident in the survey data – can be the quality of the

<sup>20</sup> Results of the survey on demand for housing in Romania conducted by the Research Institute for the Quality of Life in 1999.

existing housing stock. The relatively poor quality and standards of many of the panel blocks built during the communist era and the lack of renovation and modernization of older stock could drive the population away from their present dwellings in search of more sustainable housing. This last factor will also create a demand to upgrade the existing units. Along with the transition and economic growth, housing consumption models will most probably evolve towards those typical of developed western countries, which again can create potential demand for new housing. "Keeping up with the Jones's" already seems an important motive for households which declare great housing needs.

Potential demand for housing in Romania is not easy to assess. As illustrated in chapter II, there is a quantitative shortfall in some areas of the country, and a qualitative shortfall almost everywhere. These shortfalls are likely to grow significantly in the future unless radical action is taken. Even though this potential demand for housing seems to be rising, effective demand is seriously restricted. The key issue here is the affordability of new housing or rehabilitation work, which derives from the relationship between income and cost, each of which is itself affected by a set of factors. However, there are barriers to effective demand other than affordability.

On the demand side, the dynamics of household incomes throughout the 1990s generally reflected the ups and downs of the Romanian economy, as shown in table 18.

Table 18. Real salary index (previous year = 100)

Year	1992	1993	1994	1995	1996	1997	1998
Change	87.3	83.2	100.1	111.9	109.4	77.4	103.5

Source: National Commission for Statistics.

Very low or negative growth in real salaries, starting from a low base salary at the beginning of the decade has adversely influenced the general affordability of housing for most Romanians. Nor is the structure of household expenditure conducive to mobilizing funds for housing investment: in 1998, in households of employees, 67.6% was spent on food, beverages and clothing. The expected future increases in utility bills will further reduce the affordability of housing investment, as will taxes. Most homeowners are exempt as yet from property tax (0.3–0.5% of the book value – US\$ 50 per 50#m<sup>2</sup> a year); but this exemption will expire soon. Arrears also dramatically affect the value of the property as an asset that can be liquidated or used as collateral, and whole blocks can be cut off from access to finance in this way.

On the cost side of the affordability calculation are the high prices in the construction sector. This can be attributed to:

- The high cost of building materials, resulting from the monopolistic position of newly privatized and consolidated domestic producers, coupled with protection of the internal market by high tariffs on imported materials;
- The restricted supply of land for new housing construction, resulting from
- Unresolved restitution issues,
- The undecided ownership status of plots,
- The little land left within urban areas, where access to infrastructure would be relatively easy, following earlier policies of compact development,

- Planning restrictions on extending built-up areas in areas with development pressure, combined with restricted access to infrastructure for potential building plots due to the austerity budgets in local government, and
  - Bureaucratic and lengthy procedures in the planning/building process, some of which entail high administrative fees;
  - The high cost of credit for developers or building companies; and
  - An undeveloped market in land or property, with little competition, (allegedly) high profit margins, and a suggestion that speculators may be hoarding land to keep prices high.

Prices of new dwellings (standard small apartments) hover around US\$ 300–400/m<sup>2</sup>, roughly two or three times higher than the average annual income of a household. In view of the above, buying a newly built apartment or house is beyond the means of most Romanians.

Another income-related barrier to effective demand is the restricted access to housing finance. This is due to the fact that Romania does not have a developed market-based housing finance system. As a result, prospective homeowners or those willing to refurbish their property have a very limited market offer. While the options that would best suit their needs are simply not available, a more obvious reason why access to housing finance is restricted in Romania is the price (interest rates) of this kind of financial product. The Government has been taking measures to make housing more affordable and improve access to housing finance for certain target groups of potential homebuyers (see section C).

Effective housing demand in Romania may also be hindered by non-income-related factors. One that should be mentioned here is consumer preferences, which may be directed to other goods, like cars or other durables. Between 1993 and 1998 the number of cars per 1000 inhabitants increased from 76.2 to 118.8 (i.e. by 65%)<sup>21</sup>, and the car market is still growing despite the low growth in real incomes. Since the cost of a car can be comparable with housing investment expenses (especially with buying and upgrading existing dwellings), this trend could be taken as indicative of consumer preference. That, however, would be to ignore the distortion that might be due to inadequate access to housing finance, and to the historically derived misconception of the value of housing.

### **C. Public spending on housing**

As seen in the previous chapter, housing provision is the general responsibility of the local authorities, so it is to be expected that the State will provide the necessary financial resources and other instruments so that the authorities can comply with any legal requirements in this area. In government budgeting terms, the border between central and local investment in housing is unclear. However, it can safely be assumed that whatever public housing construction is going on in municipalities will be subsidized by the State. Private borrowing by the local authorities is possible though, as yet, very uncommon; since the risks associated with collateral and income streams would be too great for banks at present.

The State budget for the year 2000 planned expenditure of 143,755 billion lei, of which 1,097 billion was to be spent on housing (0.76%). Other housing-related expenses included 1,200 billion lei to be transferred to local authorities as co-financing for infrastructure projects in

<sup>21</sup> Source: Romanian Statistical Yearbook 1999 (electronic version), National Commission for Statistics.

international assistance programmes, 317 billion lei for paving roads and other infrastructure in rural areas, 45 billion lei for completing urban development plans, 14 billion lei for implementing the cadastre system, and 1,300 billion lei as heating energy subsidies<sup>22</sup>.

The last of these items – larger than State investment in housing itself - is the most significant, in view of the poor energy efficiency of most apartment blocks, and the expected marked rise in utility costs. Utility subsidies go mostly to the utility companies to cover some of their losses from price controls and arrears in payments. Households are compensated for increasing heating tariffs by the so-called "winter subsidies".

Apart from direct subsidies, recent amendments to the Law on Value-added Tax provide for 0% VAT on housing construction. The reduced rate was originally meant only for the National Housing Agency, but was finally extended to all housing construction.

Local authority budgets are made up mainly of the local share of national income tax plus subsidies from the State budget. Independent sources accounted for 24.7% of total local government revenue in 1998 and, since 1993, the local authorities have tended to increase their own revenue and to depend less on their share of income tax. Government subsidies remain fairly stable, however, due mainly to the increase in transfers for local investment in public amenities. In 1999, housing-related expenditure constituted 37% of total expenditure<sup>23</sup>, but the budgets themselves generally decreased in real terms and in 2000 they were expected to be 75% of the 1999 figures in real terms.

Despite housing-related spending being such a large item in local budgets, the authorities are not able fully to meet the needs of the local communities, at least in quantitative terms. The reason for this is that expenditure is either non-investment or on general infrastructure. In the city of Brasov, for example, the waiting list for municipal housing has 15,000 households on it, representing a large part of the city's 310,000 inhabitants. Although the waiting list is not solely composed of those in serious need of housing, the number reflects the extent of the community's unsatisfied housing aspirations, and the real level of overcrowding in the existing stock. The Brasov budget for the year 2000 totals 400 billion lei, but only 17 billion lei (4.25%) will be spent on providing dwellings to those in need<sup>24</sup>: sufficient merely to construct or purchase several dozen apartments.

Given the local authorities' small budgets, most housing investment is financed or co-financed from central budget programmes. Housing activities for which budget funds were allocated in 2000 were:

- Housing loan interest subsidies,
- The National Housing Agency's scheme for pump-priming new construction,
- Subsidies for social housing construction,
- Subsidies for the completion of unfinished buildings,
- Consolidation of properties damaged by or in danger from earthquakes.

<sup>22</sup> Law on the State budget for year 2000.

<sup>23</sup> Based on data published by the Ministry of Finance at [www.mfinante.ro](http://www.mfinante.ro).

<sup>24</sup> Interview with the Brasov city hall officials, 22 July 2000.

### *Interest subsidies*

The programme of subsidized housing loans for young couples was operational in 1997-1999 and attracted about 11,000 households. The last budget allocation was in 1999, and since 2000 no new entrants have been allowed into the system. Under the legislation, young households (preferably white-collar employees in rural areas) were offered long-term fixed rate (15%) loans to purchase their first dwellings, and the age limit for eligibility was 35 years. The loans were disbursed through the State Savings and Deposits Bank, and the State subsidy covered the difference between the fixed rate and the adjustable market rate charged by the Bank. The minimum downpayment was 30% of the property value and was also covered by the budget grant. Most purchases in the programme were for existing dwellings, which are distinctly cheaper than newly built flats. Since one aim of the programme had been to stimulate construction, in 1999 the policy was amended to stipulate that 70% of the loans had to be used to finance the purchase of newly built housing.

### *National Housing Agency*

The policy shift from using government funding to bring down the price of housing to using it to stimulate new construction output is continued in a new government programme of affordable housing construction by the National Housing Agency. The programme, which was launched in September 1999, is the Agency's first venture.

The Agency is supposed to provide Romanians with decent housing, and the programme to relaunch new housing construction is the Agency's first activity to this end. Financial resources for the programme come from an international credit of US\$ 300 million granted to the Romanian Government, which will be transferred to the Agency as a State budget allocation. Apart from public subsidies, the Agency's income will derive mostly from interest on loans, bank deposits and government bonds. The Agency is also allowed to issue medium- and long-term bonds, guaranteed by the State.

The Agency acts both as a developer and a loan-funding institution. As developer the Agency approves contractors, supervises construction and finally sells the units to eligible households. To qualify, the prospective homebuyer has to fill in an application form and send it to the Agency, which preselects the eligible applications and forwards them to the bank (Romanian Commercial Bank, chosen on a tender basis). The bank analyses the applicant's ability to repay and issues a so-called "solvency certificate". The applications with solvency certificates are returned to the Agency, which finally decides which applicants will get a dwelling. The beneficiaries are selected according to a number of criteria divided into three groups:

- Loan parameters,
- The applicant's personal situation, and
- The applicant's credit history.

Applicants score points against the various criteria. The points, however, are not simply totted up, it is the highest score for any criterion in any group that counts. The higher the number of points, the higher the applicant is on the list. The point scoring criteria are summarized below:

Table 19. NHA criteria (as of May 2000)

<i>Criterion</i>	<i>Number of points</i>
<b>Credit parameters</b>	
Downpayment (for applicants under 35 years of age)	
• First 10% of total loan	10
• Every additional 2%	+ 2
Downpayment (applicants over 35)	
• First 20%	10
• + 2%	+ 2
Loan term	
• 10 years	30
• + 1 year	- 2
<b>Applicant's situation</b>	
• Married	10
• One-parent family	8
• Single with a dependant	3
• Single without dependants	0
• Additional dependants (/handicapped dependants)	2 (/3)
• Applicant handicapped	10
• Applicant's dwelling destroyed by natural disaster	40
• Does not own or rent dwelling	25
• Evicted as a result of restitution	10
• Evicted as a result of retirement from service	10
• Rents a dwelling with less than 6 m <sup>2</sup> per person	10
• Rents a dwelling with 6.1–8 m <sup>2</sup> per person	5
• Evicted as a result of court decision	5
<b>Credit history</b>	
• Takes out a loan for the first time	15
• Took out a loan but defaulted (and was evicted as a result of court decision)	5

Source: National Housing Agency.

The Agency puts the construction work out to public tender. The contractors have to provide their own designs and financial packages. The designs have to use traditional materials and conform with EU thermal insulation standards. The period of construction cannot exceed 12 months. The construction cost limits are also fixed by the Agency. The maximum profit margin for the contractor is 5%. The final price is stipulated in the contract and includes a fixed estimate for inflation, which is an incentive to finish construction quickly. Apart from the contract between the Agency and the building company, the individuals have separate contracts with the building contractor, because, as owners of the land, they have an equity interest as actual investors. In multi-household buildings, no construction can begin until 70% of the apartments have been presold.

There are arrangements which keep the prices of NHA dwellings lower than market prices. The Agency is obliged to make arrangements with the respective local authorities to support its housing schemes. Under such arrangements, for example, serviced plots of land are provided free of charge by the authority. The legislation stipulates that the final beneficiary is



granted the ownership or the right to use the land for the entire life of the building on preferential terms. The beneficiary will also be exempt from property taxes during the loan repayment period and the cost of issuing the building permit is covered by the NHA.

The NHA will also act as a creditor to selected applicants. Legislation enables the Agency to grant mortgage loans from its resources to investors (individuals and legal entities) and to general contractors. These loans are supposed to be offered at belowmarket interest rates. The loan is funded from the Agency's resources, but, as the Agency is not a financial institution, the actual credit contract is concluded between the customer and a bank, which has a cooperation agreement for this purpose with the Agency. The bank is a representative of the Agency in relations with the borrowers just as the Agency represents the customer in relations with the building contractor. The terms of the NHA loans as of July 2000 were as follows:

- Duration of up to 20 years,
- Minimum downpayment of 25% of the value of the property,
- Denominated in euro,
- Interest rates starting from 7% for individuals and 10% for legal persons,
- Equal instalments throughout the repayment period,
- Mortgage on purchased property as collateral, and
- No court decision required to repossess the property in case of default.

In mid-2000, some 300 apartments were under construction, and completion of the first 60 dwellings, in three 4-storey blocks in Brasov was scheduled for the end of the year. The Agency also granted 110 loans for the purchase of existing dwellings.

### ***Social housing***

A new social housing construction programme was initiated in 2000, financed from an international credit line of US\$ 340 million, of which US\$ 280 million is to be spent on infrastructure construction in rural areas and the remaining US\$ 60 million on public rental housing. The projects funded by this loan, which are to be built to strict quality standards, have to be approved by the Ministry of Public Works, Transport and Housing, after which the Government will invite tenders from building companies, which also have to offer a financial package. The subsidy cannot exceed 60% of the construction cost and will be paid to the municipality once the construction is completed. The success or otherwise of this initiative will almost certainly depend upon the ability of the local authorities to ensure that financial arrangements prior to receipt of the subsidy can produce affordable housing for those in need cost-effectively.

Further social housing is financed exclusively from local budgets. Usually local authorities use their own funds for the purchase of existing dwellings – i.e. buying back former social housing - to replenish their stock. In Bucharest, however, the City Council prefers to build new dwellings, even when it is not supported by the State budget. The reason is that new housing will be safer and better insulated than the 25 to 30-year-old dwellings available. Recently, newly constructed social units in Bucharest outnumbered purchased ones by a factor of 3.

Usually, no special funds are allocated in local budgets for renovation, which has to be financed from rents collected by municipal housing management companies. As a consequence

– and because of the authorities' relatively low revenue –they are not investing sufficiently in repairing and maintaining their stock. Therefore, as in the private sector in general, the overall standard of the housing stock is declining with time.

### *Unfinished buildings*

There is a programme aimed at completing the blocks of flats which had been started by the Government before 1990 and never finished due to the subsequent withdrawal of the State from direct housing provision. The problem was particularly acute in Bucharest, where some 25,000 dwellings had been left unfinished. The completion work started as early as 1990 and was carried out mostly by the local authorities. In 1994, Ordinance 19 was adopted to provide for central government assistance for completion; and special funds were set up locally to raise capital for completion. The funds are made up of proceeds from the sale of finished dwellings, matched by central budget subsidies. In Bucharest, the local administration had completed 10,000 units by the end of 1993, and then a further 10,000 under Ordinance 19. The programme is now slowing down, with fewer than 500 units expected to have been finished in the year 2000.

### *Consolidation*

Romania being an area of major seismic activity (see fig.1.1), built structures need to be resistant to earthquakes and respect certain safety standards. Unfortunately, some of the existing – especially older – housing stock does not do so. The Government is addressing this issue through a consolidation programme. Two kinds of activity are financed through the programme:

- The identification of the most endangered structures by technical analyses,
- The actual consolidation work.

A number of buildings have already been identified as class 1 endangered and tender procedures to select contractors started. Budget allocations for consolidation are relatively low. In Bucharest, only 12 consolidation projects were being prepared in July 2000. Assistance is transferred either as grants or interest subsidies for families with above-average incomes, who can obtain loans to finance the consolidation work.

## **D. Mortgage markets**

As in other central and east European countries, the financing of housing investment in Romania relies almost exclusively on investors' cash resources and informal lending (from family or friends). Some financing comes from the government programmes described in section C. Long-term growth of investment in housing requires, however, an effective market-based housing finance system, which can be defined as the institutional and legal arrangements in the financial market which are intended to provide access to finance for housing-related investment. Three basic models of housing finance system can be distinguished in terms of the way the capital is raised by the lending institution:

- Commercial bank model – loans funded from short-term deposits (present universally on a bigger or smaller scale),
- Contract savings model – loans funded from long-term deposits of other participants in the system (distinct local variations in countries like Germany, France or the United Kingdom),

- Secondary market model – loans funded on the capital market through different types of securities issued against existing loans (basic in the United States and Denmark, very strong in Germany and the United Kingdom).

It is by no means certain which of the three systems will prevail in Romania. Commercial bank lending is only just beginning to develop, and a legal base for secondary market development has already been adopted. Additionally, there are indications that contract savings institutions (German *Bausparkassen*) are interested in entering the Romanian market. Still, there are some basic macroeconomic, institutional and legal requirements that the economy and the banking sector will have to meet before any housing finance system can be established in the country:

- The inflation rate has to be relatively low, though not necessarily one-digit, or
- With higher inflation rates, the economy would need to present good prospects for them to fall;
- Basic institutions guaranteeing a true market economy, and especially a market-oriented banking sector, including a strong, independent central bank with a successful record of supervision over credit institutions;
- A reliable system for the confirmation of title to property; and
- The means for the housing aspirations of households to be transformed into effective demand for housing finance.

### *Inflation*

Compared to most central and east European countries, Romania was much less successful in curbing the high inflation typical of the early stages of economic transition. Over the 1990s prices proved very volatile, and although in 1996 inflation was brought down to 32.3% (from 136.7% in 1995), it rocketed up to 154.8% in 1997. The subsequent inflation rates were 59.1% in 1998 and 45.8% in 1999. With such high and volatile inflation rates, it comes as no surprise that housing finance systems are developing slowly in Romania. However, recent economic policy statements, such as “The National Medium-term Development Strategy of the Romanian Economy”, show a determination to improve the macroeconomic indicators and create better conditions for the development of the housing finance in Romania. The Government planned an inflation rate of 25% in the year 2000. Success in doing so would certainly open good business opportunities for those interested in lending for housing in Romania. The level achieved is estimated to have been 43.5%, which means that this foundation of sound housing finance is still a matter for the future.

Inflation affects housing finance mostly through interest rates, which are decisive for the affordability of housing loans. Unsurprisingly, interest rates are fairly high and volatile. Table 20 illustrates the development of average lending and deposit rates offered to non-bank customers in 1997 and 1998.

Table 20. Interest rates for non-bank customers in 1997 and 1998 (% a year)

Month	Lending rates		Deposit rates	
	1997	1998	1997	1998
January	53.2	59.8	39.0	36.3
February	69.7	62.0	58.7	40.1
March	108.0	62.1	96.6	40.6
April	112.7	60.7	94.9	39.6
May	109.0	57.4	87.5	38.2
June	91.4	53.2	73.8	34.3
July	69.0	48.5	47.4	32.4
August	52.8	47.0	38.4	32.1
September	49.8	47.9	33.8	33.5
October	48.1	53.0	32.7	37.5
November	50.5	54.3	32.9	40.4
December	55.6	58.9	34.1	42.3

Source: National Bank of Romania, *Annual Report 1998*.

The volatility of interest rates makes housing loans typical adjustable rate mortgages with very frequent adjustment periods. Banc Post, for example, adjusts rates on its housing loans every two to three months.

Table 20 shows another feature of the current interest rate situation, namely the existence of large spreads between deposit and lending rates, usually between 10% and 20%. This can be seen as symptomatic of the high risk entailed in the lending business (and consequently the tendency for banks to invest in lower risk Treasury bills, which in addition are offered at favourable rates). It may also indicate inefficiencies in banking sector operations; however, this situation is likely to improve, as the legal environment for banking activities is improving and the banking sector is being privatized and restructured.

### ***Banking institutions***

At the end of 1998 there were 45 banks in Romania, with total net assets of 130,500,000 billion lei. The number of banks is indicative of the fast development of the banking sector since 1991, when there were only eight banks in Romania. Most banks are newly established medium or small private banks (Romanian, but with foreign or domestic capital), or branches of foreign banks. Only one bank (CEC) is wholly owned by the State, although the State is the majority shareholder in the few big banks, and the Government has already declared plans for their privatization.

The sector reacts quickly to the general performance of the country's economy. The upsurge of inflation in 1997 affected the banking system's key financial indicators; and in 1998, the ratio of non-performing loans rose to 54% (from 43% in 1996), half of which were not properly collateralized. It should be noted, however, that if problem banks are excluded, risk credit ratios are much more favourable. However, this phenomenon mostly concerns lending to companies; lending to households is much less risky. However, though increasing, lending to households is still low: at the end of 1998 it represented 5% of all credit, of which overdue credit

accounted for only 3.3%<sup>25</sup>. Although bad loans affect individual banks' financial standing, the sector as a whole does not seem to be in danger of collapsing, thanks to the well-developed and prudent regulatory framework of the National Bank of Romania, and its effective bank licensing and supervision policies.

The banking sector shows strong prospects of development and competitiveness, including in lending for housing business. Lending for housing purposes is one of the objectives of a number of existing banks<sup>26</sup>:

- Romanian Commercial Bank (majority State-owned, big),
- Romanian Bank for Development (privatized, medium),
- CEC (State-owned, medium).
- Banc Post (privatized, small),
- Bank Ian Tiriuc (private, small),
- Bank Transylvania (private, small).

The above-mentioned banks offer market-rate loans for housing purposes. However, their operations in the housing market are fairly limited. If we discount CEC, which until recently offered subsidized housing loans, credit for housing purposes forms a very small portion of banks' total assets (1–2%). The terms of the housing credit product currently offered to individuals by the Romanian banking sector can be illustrated by the example of Banc Post.

In August 2000, Banc Post was offering two types of housing loan, and was about to introduce another type. The three are:

- The short- or medium-term loan for buying and/or upgrading properties (2–5 years),
- The long-term construction loan (up to 15 years),
- The mortgage loan (new product).

The basic difference between the construction loan and the mortgage loan is the way the credit is collateralized. Until recently the banks could not accept the property that they were to finance as collateral. With the construction loan, Banc Post accepts as collateral real estate other than the property being purchased, the value of which has to be 25% higher than the loan plus annual interest. Banking Law rules apply to foreclosure, which means in practice that the lender would have to go to court to foreclose, and, if the court decision were favourable, supply the evicted borrower with alternative housing – a socially supportive measure, which unfortunately hinders the lending of money for housing construction. In contrast, the mortgage loan granted under the Law of 1999 can be secured by the purchased or constructed property being financed. Repossession of the collateral is effective at 30 days' notice without any judicial procedure nor the need to provide the borrower with another dwelling. Presumably, the other terms of a mortgage loan will not be very different from existing products, that is:

- Interest rates – adjustable (in the case of a mortgage loan - under the Mortgage Credit Law - rate adjustments have to be related to certain reference indexes approved by the National Bank of Romania),
- Minimum downpayment – 20% for purchase and 30% for construction,
- Borrower's effort ratio – monthly repayment of principal and interest not exceeding one third of net monthly household income,
- Loan currency – Romanian lei or selected foreign currencies.

<sup>25</sup> All data concerning the performance of the banking sector come from the 1998 Annual Report of the National Bank of Romania.

<sup>26</sup> Source: The Prospects for housing finance in Romania, prepared by the Urban Institute for USAID East European Regional Housing Sector Assistance Project, December 1999.

An effective housing finance system requires an adequate supporting infrastructure, including property valuation and credit information systems. For property valuation, cooperation has been established between the banking sector and the leading association of property valuers (ANVAR) (see chapter III). ANVAR has prepared valuation standards approved by the National Bank of Romania and the Securities Commission. ANVAR has also trained 400 credit officers in the major banks. The nationwide database for property values is currently operated by ANVAR; but it has now been recognized that the service should be established on a business basis, which ANVAR neither wants nor is able to do. Romania does not yet have credit bureaux to provide banks with a prospective borrower's credit history, but a register of loans over 200,000 million lei is available at the National Bank of Romania.

The Romanian banks are clearly open to innovation in housing finance, as can be seen from a new mortgage insurance scheme to be launched by a group of banks. Apart from the obligatory insurance of mortgaged property (a requirement under the Mortgage Credit Law), the banks intend to introduce optional insurance for loan repayment, which can be used to relax credit contract terms for certain groups of borrowers. The target group is middle-income borrowers well able to repay, who are interested in good-quality housing. The Mortgage Guarantee Fund (modelled on the existing Romanian Loan Guarantee Fund) will be established with the interested banks as shareholders. The Fund's major source of capital will be the international markets. A programme is planned for US\$ 500 million worth of mortgages over 10 years (15,000 properties), and will be preceded by a pilot financing project for 60 homes. Before any guarantee will be issued, the Fund will approve the lender, the borrower and the property. The insurance premium will be 8% of the value of the mortgage, amortized over 15 years of the mortgage life. Due to credit risk sharing, the innovation should bring about lower interest rates on mortgages, and possibly a relaxation of other loan parameters, such as the minimum downpayment.

Housing loans in Romania are currently funded from short-term deposits, despite chapter VI of the Mortgage Credit Law allowing alternative funding, namely the issue of mortgage bonds against existing mortgages. The implied secondary market for mortgages seems, however, a very distant option, since the system would require a more elaborate regulatory framework than exists at present, and would still need to be worked out. Moreover, the banks have not yet been able to build suitable mortgage portfolios.

### ***Right to title***

One of the crucial issues for the development of housing finance is clear ownership rights for any real estate subject to market transactions, supported by an effective and reliable title registration system. Part of the legacy of communist rule in Romania is the countless claims to formerly nationalized real estate. It will probably take a further decade to sort out this issue. In the meantime, the unclear status of land and buildings will continue to inhibit the development of mortgage financing, because it excludes a large portion of the real estate market which is considered too great a risk for potential mortgage lenders. The Government is currently working on the country's cadastre system, one function of which will be the legal confirmation of titles to property.

### *Creating effective demand*

As mentioned in section B, restrictions on effective demand for housing are mostly income-related. New dwellings are too expensive for many people but existing units are more affordable. Similarly, the accessibility of housing finance itself can depend on the type of the product that is for sale. Under present conditions, and reflecting the level of interest rates and income distribution among the population, the potential market for adjustable rate mortgages is very restricted; and this is mostly due to the very high cost for a borrower of the initial phase of loan repayment. The dilemma currently facing most would-be house buyers in Romania is: to reduce the loan repayment/household budget ratio to a level acceptable to the bank, the loan has to be smaller, and this pushes the would-be purchaser towards cheaper property (for example, an existing unit instead of a new one). But even then, for most households, it also requires a larger initial downpayment, which they cannot afford.

Models for addressing this problem have been developed successfully in other countries. For example, in Mexico and Poland, banks have approached the need to make loans available to lower-income groups by introducing mortgage plans which distribute the burden of loan repayment in a way that is far more tolerable to the borrower. One such is a dual-indexed mortgage, in which the interest rate and monthly payment amounts are based on two different indices (repayments usually follow the movement of wages in the economy). The DIM product technology is fairly complicated, but the example of Poland shows that it can be absorbed even in the early stages of transition.

### **E. Typical financing structures**

#### *Private housing construction companies*

In Romania 90% of all new housing construction is financed from private funds. The public sector from rental housing construction. The National Housing Agency's programme and other government programmes directed at owner-occupancy are responsible for only a fraction of newly built owner-occupied dwellings.

The construction of single-family housing in rural areas is usually managed by the prospective owners without any public assistance. In contrast, new homes in urban areas are usually offered by market-based developers. Unlike some publicly supported construction programmes, described in detail in **section C**, private-sector housing projects do not entail sophisticated financing patterns. The initial project capital, which is sometimes funded from a short-term loan, buys the land and covers the administrative costs of the necessary permits. Before any actual construction work starts, the developer pre-sells some or all of the dwellings to be built in order to obtain finance for the construction work. A standard initial instalment for prospective owners is 15% of the agreed purchase price of the property. Instalments are indexed to a foreign currency, typically the United States dollar, and customers often offer to pay much more up-front to protect against the effect of inflation on exchange rates. Such prepayments can then be treated as credit to the developer and bear an annual interest of 10%. Late payments, however, will be treated as credit to the customer, for which the developer will charge something like 14% a year. The development company is additionally insured against losses as a result of late payments. The money for instalments can come either from the purchaser's savings or from

a loan. As indicated in the previous sections, housing investment is still financed primarily with cash.

### *The funding of housing-related infrastructure*

The municipalities are responsible for providing access to sewerage and water networks, while national utility companies provide other types of infrastructure. While funds for large-scale infrastructure projects, and some infrastructure in rural areas, can attract international assistance – e.g. programmes mentioned in **section C** - the financing of service provision in urban areas is problematic. The limited investment capacity of local authorities and utility companies forces the providers to seek investment capital elsewhere, or to fail to meet their obligations. Typically, therefore, if they are to develop housing on a piece of land, developers will have to finance the construction of the infrastructure networks themselves. As they cannot own the infrastructure, they have to transfer it free of charge to the relevant utility companies, which implies ultimately a cost to be borne by the final home-buyer. The situation for commercial housing developers is about to become even worse, since municipalities are now obliged to dedicate funds primarily to infrastructure for land to be used in NHA projects.

### *Maintenance and renewal*

The Romanian tenure structure is heavily biased toward owner-occupation. Normally, this might be expected to have a positive effect on the finance available for maintenance and renewal. However, this is not the case in Romania, since most owners are not rich. The financing of renovation is particularly problematic in the multi-family stock, whose owner-occupiers are the result of either restitution or the “give-away” privatization process. In particular, the common parts of the multi-family buildings often need serious repairs or modernization. The joint-owners’ ability to pay for proper maintenance, let alone dedicate additional resources to renovation work, is very restricted. For organizational and cost reasons a loan for this purpose is an even more distant option. Currently, the State does not offer any subsidies to owner-occupiers to solve this problem. There are micro-finance schemes using international resources; but their scope is very restricted. On the other hand, the market for refurbishing individual dwellings seems to be blooming, giving employment to a multitude of petty entrepreneurs. This kind of renovation is increasingly financed by bank credit.

The situation in rented stock seems no better. Rental housing is mostly in municipally owned stock. Rents are regulated by legislation. According to the Housing Act, rent should cover “maintenance, repair, taxes, return on investment”, which, if applied, would provide sufficient income to landlords. However, the rents cannot be raised above a legal ceiling of 25% of the household’s income. This level is deemed to be economic, and to yield an income stream able to cover the expenditure recognized in law as necessary; however, given the relatively low incomes of current tenants, it is usually insufficient for proper maintenance and repair.

The situation is even worse in the social housing rental stock, whose tenants can be charged no more than 10% of the household’s income. Legislation places the same responsibility on landlords to ensure the upkeep of the properties, but assumes that the difference between rental income and expenditure can be covered from the local authority’s budget. The authorities find that other urgent priorities prevent this, which implies that the social housing stock will be deteriorating even faster than in the private sector.



Up to 1999, when rent levels were adjusted to catch up with general price inflation, rents in Romania were symbolic, and amounted to 300 lei/m<sup>2</sup> per month. Currently in Bucharest, they range from 7,000 lei/m<sup>2</sup> in zone I to 2,000 lei/m<sup>2</sup> in zone III. Around 40% of non-social rental stock in the city falls under rent controls (i.e. is subsidized). Social housing in Bucharest forms a very small portion of the stock and is allocated to the poorest families. In the year 2000 only about 4 billion lei were allocated for repairs to public stock in the Bucharest municipal budget.