

HOUSING FINANCE DEVELOPMENT IN UZBEKISTAN

TECHNICAL NOTE

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Introduction

1. **The Government of Uzbekistan has adopted an important series of initiatives to create a market-based housing finance system, yet recognizes that there remains much work to be done.** Reforms started with privatization of housing in the 1990s, and furthered most recently with the adoption of the President's Resolution "On Further Development of the Housing Market."¹ There is broad recognition of the need to develop housing markets and housing finance, particularly given the demand for housing, and the potential as a stimulus for employment and investment in the production of building materials, durable goods, and banking services. Since real estate and construction is largely a non-tradable industry, the local multiplier effect of investment is enhanced as most of the investment benefits the domestic economy. In spite of these reforms, the current financial system and real estate markets remain seriously deficient.

2. This note provides guidance on the themes that were discussed with authorities and industry participants during mission to Uzbekistan on November 6-16, 2006 and February 22 to March 2, 2007. The note is based on missions conducted in 2006 and 2007 by Britt Gwinner, FPDSF, and Michael Borish, a review of government documents, and a review of studies conducted by other multilateral institutions. It benefits from cooperative research and analytical work done by the local staff of IFC Central Asia Primary Mortgage Market Development Project in identifying the legal and regulatory gaps in the country's housing finance system, as well as their additional background research under the TOR for developing this note. The World Bank would like to thank the officials of the Ministry of Finance, Ministry of Economy, Ipoteka Bank, and others for their generous cooperation.

Conclusions and Recommendations

Priorities for Government Policy

3. **Expansion of housing finance will require a substantial effort to reduce inflation, build technical capacity at banks, and implement real estate market reforms.** The reform process for residential mortgage lending is in its early stages. Mortgage lending is a new product for Uzbekistan's banks, and for its public authorities. It is highly unlikely that a long term lending market will develop as long as inflation remains at the current levels as evidenced in producer price growth, the GDP deflator, and bank deposit rates. Restrictions on the use of cash in financial transactions constrain the ability of banks to create a healthy cycle of savings and investment in construction and housing finance. Banks should develop operational systems and credit underwriting

¹ Resolution of the President of the Republic of Uzbekistan # PP-10 "On Further Development of the Housing Market", dated 16 February, 2005.

capacity specific to mortgage lending. Although a liquidity fund has been created on paper, there is no operational provider of long term funding for mortgage lending. There are no pricing benchmarks for long term mortgage loans. Residential rental markets are largely informal. There exist as of yet only a few elements of a market-based system for delivering new housing, particularly at moderate and low prices. Land privatization has just started, and its progress is slowed by the difficulty of assigning prices to ownership rights that in many cases have never been traded. In the mean time, the allocation processes for usage rights for urban land are opaque, providing opportunities for corruption. The recent rise in property prices in Tashkent and other cities is a result of higher incomes, remittance flows, population growth, and the lack of supply response for moderate and low cost units.

4. **The government's recognizes that there remains much work to be done, and imposes ambitious deadlines on separate reform steps.** Many of the required steps involve the development of institutional capacity and complex management and automated systems. In the first year or two, expectations should be modest for the volume of mortgage lending. It has taken between eight to fifteen years to generate a substantial volume of lending in countries such as Malaysia, Colombia, and Mexico.

5. **Without a reasonably efficient primary market, there can be no mortgage securitization or covered bonds.** The first priorities should be strengthening the loan origination and servicing capabilities of lending banks, creating a system that delivers new housing, and reforming real estate markets to ensure their efficient operation. It must be possible for lenders to enforce the mortgage lien in case of default so that the mortgages can serve as collateral for mortgage related securities. Once there exists a regular and adequately large production of mortgage loans, banks may consider starting with portfolio sales among banks, then turning to the MLSF for liquidity funding, and finally to developing capital market funding tools. While the government should develop legislation to permit covered bonds and securitization at any time, it cannot expect any issuance until the primary market is operational at some minimal level.

6. **Near term priorities should be in three areas: the primary market for mortgage lending, the residential real estate market, and the legal and policy framework.** To make affordable housing available to moderate and low income households, it will be necessary to have a reasonably efficient and transparent market for urban land, production capacity on the part of developers to build affordable housing, and banks that can separately finance construction and the purchase of housing with mortgage loans. Public policies need to support enforcement of contracts, transparency of markets, and efficient processes in areas such as permitting, land allocation, and real estate transactions. See Table 1 for an outline of recommended policy initiatives in each of these three areas, as well as their proposed timing.

Table 1 – Three Simultaneous Housing Policy Tracks			
Time	Primary credit markets	Real Estate Markets	Legal Issues, Policy Initiatives
	Develop mortgage lending standards, set priorities for target markets to be supported by government-sponsored lending.	In context of residential land privatization, solidify and clarify ownership rights, increase the supply of urban land for residences, ensure an adequate portion is made affordable for households earning less than the median income	Reduce inflation and keep it low to make long term finance as affordable as possible
	MLSF finances short term, low loan-to-value loans at market interest rates for renovation, trade-up from one privatized apartment to another.	Revise national standards and funding programs for urban planning, land management, and zoning to ensure adequate supply of low cost housing	Develop a housing policy that addresses markets for real estate and finance, reforms subsidy programs to insure their focus and efficiency, coordinates local and national policy and programs, collects and publicizes data on real estate markets and real estate lending
	Develop technical capacity at banks for retail credit evaluation, market risk management, operations and systems development. As conditions permit, MLSF finances market rate long term mortgages by banks for moderate and low income households.	Create transparent and efficient processes by municipalities to allocate urban land for residential use, transparent public auctions of land to developers, ensure a broad mix of household incomes in new developments	Use the independent research center and local realty associations envisioned in the Government's national program for housing finance to evaluate existing subsidy programs to enhance their efficiency and equity
One Year	Develop technical capacity at banks for construction project management skills	Consider underutilized public land, public facilities (for example obsolete military or educational facilities) to make available for new housing developments. Pilot targeted low income lending programs.	Ensure efficient enforcement of mortgage lien in case of default, including foreclosure and eviction. Any re-housing requirement to be funded by the national government rather than by banks.
		Consider government funding of land banks for economically integrated housing development	Ensure enforcement of international standards for property appraisal, real estate brokerages
Two Years	Develop technical capacity to issue mortgage related securities	Complete efforts to improve efficiency, transparency of property title and mortgage lien registration and transfer	Legislation to encourage consumer protection, contract enforcement in real estate transactions, disclosures, escrow accounts and trusts
	Potentially develop loan designs that help to cope with persistent inflation, such as indexed loans		Legislation to enable issuance of mortgage bonds and mortgage backed securities

7. **Developing financing capacities in residential construction and individual mortgages is an excellent means to enhance the role of banks as intermediaries of savings and investment.** Currently, confidence in the banking system is very low. Banks raise only one third of their liabilities in domestic deposits, and the ratio of total banking sector deposits was about 8 percent in 2004, among the lowest in the CIS. In 2004, more than 70 percent of bank loans were to state-owned enterprises, many of these with government guarantees. By enabling banks to develop profitable and well-managed construction financing and mortgage lending programs, while relaxing restrictions on banking activities, the government could contribute significantly to a virtuous cycle of domestic savings and investment. Banks could offer contractual savings products that enable individuals to establish a credit record and a down payment. In many economies, retail and institutional deposits form the basis for bank lending for construction of moderately priced residences, and lending to individuals for purchase money mortgages.

Revisit the Role of the Mortgage Lending Support Fund

8. **Separate the two roles of the Mortgage Lending Support Fund (MLSF): 1) liquidity facility for commercial mortgages and 2) distributor of subsidies.** The MLSF could serve as a catalyst in the creation of a self-sustaining cycle of longer-term lending and savings if it prices long-term lines of credit to banks according to commercial terms. Such lines of credit would permit banks to extend the maturity of their loans at commercial terms, and make mortgage more affordable.

9. **Financing loans at sub market interest rates will be bad for the MLSF and it will not help to develop a mortgage market.** Lending the MLSF's current capital at a rate of 5 percent would not help to create a lasting housing market. With Soum 4.9 billion (USD 3.9 million), the fund could finance about 200 apartments at its price limit of USD 25,000 each, while eroding the capital of the fund in real terms.² This would be a very small contribution in a country where more than 60,000 new households are formed each year. For the MLSF to make a sustainable contribution to the market, it has to set interest rates for its loans that compensate for the costs of doing business, including inflation. A more tenable approach would be to provide market pricing for primary lenders based on positive real rates and to fund these with bond issues to be purchased by insurance companies, the reformed defined contribution pension plans, and banks. Until inflation and interest rates fall, the MLSF could provide liquidity for commercial bank mortgages at market rates of interest for short maturities for renovation or for trade-ups to larger privatized apartments.

10. **In addition to lending, an institutional champion should lead the development of the mortgage market in a number of ways:** (1) work with the Statistical Committee to define, collect, and publicize data on real estate markets to contribute to market transparency and efficiency, (2) lead the effort to pass additional legal reforms for mortgage lending and land markets, (3) Build technical and operating capacity at lending institutions by utilizing International financial institutions such as IFC, and (4) pilot alternative credit products such as lease-to-buy. These initiatives would

² Assuming each loan was for 80 percent of the purchase price.

in turn support the Government housing finance strategy. For instance, data collection on real estate markets could serve as the basis for realty market development and the independent research function articulated by the government. Legal reforms could encompass plans for real estate activities, new accounting and appraisal standards, mortgage bonds/securitization, etc. Institutional capacity support could focus on appraisal standards and professional certification, realty service development and data dissemination, government and banking sector data related to housing/real estate/urban planning issues, uses of such data (from The government, realty associations and banks) for market advancement and deepening, and the development of construction lending by banks.

11. Rental housing and lease-to-buy could be used to reach low income households with higher standard housing on market terms. Very low income households typically lack the resources to buy and maintain a housing unit that meets most country's quality standards. The financial system can profitably fund the construction of rental or leased property for such households. Lease-to-buy can make ownership available to those who have been unable to accumulate a down payment.

12. National and local governments can slow house price inflation by increasing the supply of real estate and by reducing the costs and risks of buying and selling property. Construction of affordable units will rise as it becomes a profitable business for developers. This cannot occur unless land is made available at a cost that permits moderate and low income households to purchase. Land prices are more likely to be affordable if the process for allocating land and eventually selling it once privatized is transparent, simple, and inexpensive. Municipalities should create incentives and rules that lead to the development of economically mixed communities that adhere to international norms for public space and amenities. Isolated communities of low income households have led to the creation of social deprivation and urban unrest in many countries.

Redesign Housing Subsidies

13. The most successful housing policy frameworks make use of the private sector to build and maintain housing, and reserve any subsidies for households that most need assistance.³ Such policies expect upper and middle income households to pay for their own needs in the market. If necessary, the government may provide incentives to the private sector for limited periods of time to encourage lending to moderate income segments. The government provides deeper subsidies for the lowest income segments in cooperation with the private sector where possible.

14. It is important for the government to develop an overall vision for the provision and targeting of housing subsidies so as to reach the households that most need assistance and to employ public resources as efficiently as possible. The few existing housing assistance programs are fragmented, ad hoc, and often not operational

³ See Annex 2 for examples of well-targeted housing policies and subsidies and Annex 3 for a summary of the advantages and disadvantages of different kinds of subsidies.

due to a lack of funding and improper targeting mechanisms. The lack of reliable information and the inconsistent nature of housing assistance efforts on the part of the authorities make it impossible to provide any development impact assessment of existing initiatives on the ground (e.g. evaluating groups of low-income families and other beneficiaries that actually were able to improve living conditions).

15. **In developing the subsidy policy, the government can refer to the foundations of successful programs that have been reinforced by lessons learned from other country experiences.** Key elements include (1) establishing clear policy goals, (2) designing “smart subsidies” that distort markets as little as possible and reflect market and household conditions, (3) determining specifically what to subsidize, (4) strengthening the banking sector, (5) determining a suitable role for the public sector in the mortgage lending market, (6) determining what role, if any, interest rate subsidies should play, (7) reducing origination costs to lower transactions costs, (8) implementing savings schemes that are targeted to eventual home purchases or renovations, and (9) expanding rental markets for households unable to purchase homes.

16. **The proposed MLSF interest subsidy would be expensive, amounting to 25 percent of the value of a low-priced apartment in Tashkent.** The MLSF subsidy would be more expensive to the government than one possible alternative design, giving 10 percent of the house price in cash to the prospective buyer. The proposed MLSF loan would be offered at 5 percent per annum to households. The difference between the current Ipoteka mortgage rate of 13 percent over ten years and 5 percent charged would be 8 percent. The present value of the 8 percent interest payment stream discounted at 13 percent would be USD 5,600, or 25 percent of a USD 22,150 apartment in Tashkent. If the subsidy were to be evaluated with respect to a market reference rate such as the Kapital bank lending rate of 25 percent, the present value would be half the purchase price of the house.

17. **Using rough estimates, the cost of an extensive system of up-front subsidies might be USD 24 million per year or more, or about 0.2 percent of GDP.** By comparison, Chile has spent between 1.0 and 3.2 percent of GDP annually over the past 20 years to subsidize home purchases as a means to eliminate overcrowding and provide sanitary housing to low income households.

18. In the absence of specific data on any presumed housing shortage in Uzbekistan, the construction and finance system should produce enough new units each year to house the net number of newly formed families.⁴ There are about 5.3 million households in the country. If the population grows at the five year average of 1.18 percent, about 62,000 new households would be created every year. If 30 percent of these, or 18,600 households, required an up-front subsidy of 10 percent of the purchase price of a housing unit costing USD 13,200⁵, then the total cost would be around USD 24 million. To more accurately estimate and tailor the subsidy system, detailed data is required on the actual

⁴ The net here would be the difference between new households and those that are eliminated through parents moving in with adult children, or through deaths.

⁵ 60 percent of the cost of an existing low end apartment in Tashkent

rate of household formation, average size of new households, property prices by region and city, the distribution of household income and expenditures, and production capacity. Also, it is important to consider the cost and effectiveness of all of the existing fiscal and indirect subsidies that the government provides.

19. **Subsidy programs should avoid simply giving housing units away.** Experience in many countries shows that people hold in greater value things for which they have to pay, even a minimal amount.

20. **A more successful subsidy policy would be tailored to the needs of various sub-groups of the population.** For instance, the government could provide small up-front subsidies in conjunction with mortgages to middle-income earners in rural areas. Also in rural areas, the government could take advantage of the capacity of families to progressively build their own housing. The national government could assist local governments in the provision of serviced lots with basic units that households could later incrementally expand, probably at a cost lower than that of subsidizing apartments in cities. National subsidy funds could be provided to local government in return for demonstrated reforms in administrative processes such as for construction permits and land allocation. For larger cities such as Tashkent and Samarkand, a subsidy for low income families should be tailored to local land prices and market conditions. Incentives to provide private rental apartments at low cost should be considered.

21. **The government should pilot test low income lending and subsidy programs in various parts of the country.** Pilots could serve to demonstrate the viability of serviced lots programs in conjunction with *hashar* self-construction, small subsidies with mortgages in rural areas, and lease-to-buy programs.

Make Foreclosure and Eviction Possible from Primary Residences

22. **It will be necessary to permit foreclosure on a primary residence.** The Law on Mortgage appears to be broadly satisfactory in defining mortgage as a financial instrument and associated rights. However, the legal basis for foreclosure and eviction in case of default are unclear. In contradiction of the law on mortgage, the law on court decisions forbids eviction when the collateral property is the family's primary residence. While foreclosure is the most expensive means to enforce a mortgage contract, it is necessary to maintain it as a tool for lenders. Research in Europe and North America shows that where foreclosure is certain and rapid, banks lend more for mortgages at lower rates of interest.

Improve the Operation of the Real Estate Market

23. **Real estate transactions and permits should take no more than a few days to complete, the processes should be transparent, and fees for transactions should be only high enough to cover the government's administrative costs.** This includes processes and fees for title transfer process, and lien registration. Criteria for construction permits should be transparent, and should reflect public information on zoning, land use, and building codes. The link between phone and service bills and the sale of property

should be eliminated. Phone and service bills should be the responsibility of natural persons who order a service rather than being linked to a property.

24. **The government should consider creating a legal framework and incentives that promote institutional investment in moderate-cost rental housing.** Such an effort would ease the financial burden on such households, particularly if based on an efficient, well-targeted subsidy scheme for low-income renters. In other markets when this has been a one-time feature, it has resulted in rising levels of home ownership and an expanded fiscal base.

25. **Data on housing units should be collected on the basis of unit counts and their amenities, not only on the basis of square meters.** Data on square meters can be misleading because they do not control for the size of individual units. If the bulk of new construction is for the elite market, then square meters look impressive without delivering supply for moderate and low income households. Statistics that also include housing unit counts and amenities such as the number of bedrooms, presence of appliances and services can provide a clearer picture of the nature of the outstanding stock and of new construction.

26. **Official statistical data on housing construction does not permit an accurate understanding number of units available.** The apartment count as provided by the government is distorted by the manner in which new stand alone houses are arbitrarily divided into apartments, even when they are to be occupied by single families. Depending on the size of a given building, the local authorities (who provide the data to statistical organs) convert each stand-alone house into the equivalent in terms of number of apartments. Exact methodology is not available but reportedly the key criterion for conversion is how many families each particular house can theoretically accommodate, regardless of how many families the structure is intended to accommodate. As a result, the true volumes of housing construction of Uzbekistan appear to be seriously overstated.

27. **The lack of data on land availability, construction volumes, housing prices, and housing quality impedes the development of the housing market.** The regular collection and publication of data on apartment and house prices is important in developing confidence in the real estate market and in the value of residential real estate. Value translates to asset building for individuals. The absence of such data impedes the government's efforts to assess unmet needs and design an appropriate policy. One of the least expensive measures the government can take to develop the market is to collect and publish detailed data on real estate market transactions.

28. **The requirement to disburse construction and mortgage loans in non-cash form constrains the real estate finance market.** A high premium of up to 20 percent of the purchase price is said to be required for settling real estate and construction transactions through bank transfers. The broader issues connected with restrictions on use of cash are beyond this report. However, the government should explore positive means to reduce the economic incentives to transact in cash.

Housing Finance

29. **The country's largest housing finance challenge lies in developing the primary lending market.** To serve the apparently strong demand for housing, mortgage lenders need to develop management and automated systems, experience with mortgage portfolios, and scale in their operations. As of late 2006, there were very few banks making housing loans. Ipoteka Bank is the largest housing lender, having made about \$4 million in 700 housing loans by late 2006.⁶ Kapital Bank had made about \$1 million in housing loans.⁷ This represents a very small part, 0.13 percent, of total banking system loans at the end of first quarter of 2006, and only 0.04 percent of GDP. By comparison, mortgages are a profitable and safe asset for lenders in Malaysia, representing over 20 percent of GDP, and in Western Europe and North America they constitute a large part of bank assets, and from 60 to 100 percent of GDP.

30. **It will not be possible to develop a secondary mortgage market until the primary market has developed a steady and adequate flow of loans.** Potential issuing institutions like Ipoteka bank need to develop efficient loan origination and collection systems, and demonstrate the capacity to administer mortgage related bonds for up to twenty years. The issuance of covered mortgage bonds or mortgage backed securities requires a portfolio of adequate size to cover the costs of issuance and administration of the securities. Each bond issue requires professional salaries, legal fees, registration costs, and rating agency fees. The issue has to be large enough to pay such costs as a small percent of the total portfolio. For institutional investors to profitably invest in mortgage related securities, they need to be sure of the ability to sell the bonds at a later date. Such an exit strategy requires regular bond issuance and trades, which in turn implies a steady flow of new mortgages to serve as collateral.

31. **Loan interest rates are high and maturities are short, reflecting relatively high inflation and a lack of long term funding.** Kapital lends at an interest rate of 20 percent per year, in soum, with a contractual float with the ability to change the rate by mutual consent. Kapital lends to existing SME customers that it knows. It requires at least 10 percent down payment. Ipoteka bank charges between 13 and 17 percent annually for loans for existing housing, up to ten year maximum term, average balance of soums 16-18 million with a maximum of 31 million. For new houses, Ipoteka Bank expects to participate in the program of the national Fund, lending at 5 percent for 15 years. The National Bank of Uzbekistan (the country's largest) is planning to enter the market after a year's time once it has evaluated new legislation and the results of other banks.

32. **The macroeconomic environment currently works against long-term mortgage financing.** Interest rates are the means by which financial markets price assets. In a sustainable and efficient financial market, interest rates compensate for inflation, operational costs, and risk. In Uzbekistan, consumer inflation appears to be running higher than the governments stated rate of 8.3 percent, especially given the much faster

⁶ At USD22,000 per house, that would amount to about 150 houses in a country of more than five million households..

⁷ Data was not available to the mission on the size of the mortgage portfolio of all lenders.

rise in the government's rate for producer prices and the GDP deflator. Practical evidence of higher inflation can be found in (1) bank practices of indexing mortgage loan balances during construction periods, (2) high rates required to attract retail deposits by microfinance institutions, and (3) high rates charged for loans when priced on commercial terms. It is necessary to reduce inflation if the government wants to build long term mortgage lending.

33. **Short-term lending can be used to facilitate development of the market.** Shorter term mortgages require less exposure to inflation. Shorter-term mortgages that are used for purchase by middle-income segments that have savings, or for short maturity, low Loan-to-Value (LTV) purchase loans for households that want to trade up from an existing, privatized apartment. While not targeted at low-income households, such a program could be a means to motivate institutional reforms among mortgage lending institutions, and eventually move further down market. Shorter term loans will be easier to use as covered bond collateral, as the shorter maturity requires less in terms of long-term operational capacity.

34. **Indexed lending has been used for longer maturity loans in inflationary environments in other countries.** Long-maturity fixed nominal rate mortgage credits are infeasible for much of the population with inflation running at 16 percent and more. However, a system of linking mortgage interest rates and loan principal to inflation has worked in several countries to make long term lending available to moderate income households. Successful implementation of indexed lending requires a publicly-understood and robust methodology for the measurement of inflation. To build the confidence of the public and of the financial industry, the construction and maintenance of the inflation index to which loans are linked must be a transparent process. Ideally, the inflation index used should also be applied to wages, and banks need a means to match fund indexed loans with indexed deposits. Successful relevant examples of indexing in recent years include Poland and Chile. The vast majority of mortgages originated today in Mexico are indexed. It should be noted that where indexation has worked best, as in Chile, it was in part because virtually the entire financial sector was indexed, and even more importantly because inflation was brought under control, to less than 3 percent annually.

35. **Bank credit risk, credit evaluation and financial risk management practices are rudimentary and driven by regulatory requirements.** Banks are risk averse, a legacy of government-guaranteed loans by large state banks which, until recently, had a near-monopoly on most banking activities. In the presence of government guarantees there has been little incentive by banks to develop active risk management systems.

36. **Ipoteka and Capital banks have developed basic underwriting requirements, and should consider now the data requirements for more robust methods and systems.** Current methods include: (1) income/cash flow tests (and proof of employment), (2) ratio analyses, including general household debt as well as specific principal and interest costs relative to income for the proposed housing loan, and (3) observance of reasonable loan-to-value ratios. Capital Bank loans carry net interest spreads of about 7-8 percent, and loans are made to known customers for properties that

are not primary residences, and therefore can be easily repossessed in the event the borrower defaults. Loans carry variable rates of interest, allowing lenders to match loan rates with deposit rate movements, although deposit maturities are shorter than those of loans. To develop more sophisticated credit evaluation tools, banks will need historic data on loan performance and on borrowers. Banks should plan to collect such data as soon as possible, so as to lay the foundation for better systems.

37. **Mortgage credit evaluation criteria could take explicit account of informal income.** Households earn informal income from remittances and from local economic activity. Mortgage lenders could extend affordability by working with alternative credit evaluation means to include informal income sources.

38. **Collateral and market risks may give rise to losses should the property market slow down.** The recent environment of rising property values reduces the likelihood of default and reduces expected loss in case of default. When prices are rising, properties can be repossessed and sold at values that recover costs. Mortgage lenders should have a clear understanding of the risk they are taking in a rising market. The typical manner to mitigate such risk is to maintain standards for loan to value ratios, to discount property appraisals, and to maintain strict income requirements.

39. **Over the medium term, mortgage financing is constrained by the absence of long-term funding for banks, and the eventual development of capital market funding will be important.** Lenders are not able to match the maturity of assets and liabilities, although banks have such small volumes of long-term assets they tend to show more than adequate liquidity ratios. So long as long term loans remain a small part of any bank's balance sheet, the lack of long term funding will not pose a problem for lenders. As more mortgages are issued, the absence of long-term funding for banks will severely complicate asset-liability management and will lead to exposure mismatches. The government's program document for housing constructively mentions the development of mortgage bonds for funding mortgage portfolios. The performance of these bonds will depend on the quality of the underwriting of the mortgages that back them, which reinforces the need for development of primary market capacity.

40. **The mismatch caused by the lack of long term deposits is compounded by the absence of capital markets.** The domestic corporate bond market is small, with 12 issues valued at about \$52 million as of March 31, 2006. The stock market had listed value of \$2.9 billion, although there is no way to validate what true market value would be for these shares in a market characterized by a lack of transparent conditions and reasonable levels of free float. Banks account for 14 percent of stock market value.

41. **There is no construction finance available from banks.** In countries with more developed housing finance systems, construction finance is a profitable business for banks. Banks in North America, Europe, Mexico, and Brazil have large construction lending businesses. To do this, banks employ specialists who have experience in construction project management and real estate market values. They understand the risks and costs of commercial and residential construction. Disbursements of construction loans are made against pre-defined progress points in the project. The project risk is

managed directly by the contractor, and supervised by the lender. Banks in Uzbekistan lack experience in managing risks associated with project financing.

42. **Ipoteka Bank in Bukhara already appears to be familiar with the larger local contractors, and it offers mortgage loans on unfinished properties, effectively using the mortgage proceeds to fund both the construction and purchase stages.** It manages construction risk by disbursing mortgage proceeds against stages of completion of individual homes. Since the individual home buyer is responsible for paying the mortgage, the project risk is placed on his or her shoulders, even though the individual is least able to manage construction project risk. The next stage would be to develop this expertise for larger developments of moderate and lower income housing, such as developments of multiple stand-alone houses, or of new apartment blocks, and have the responsible party for the loan be the developer. Banks and professional developers are better able than individuals to manage construction project risk and profit from the value added of managing it.

43. **The government has set aside UZS 3.9 billion for the Mortgage Lending Support Fund (MLSF) under the Ministry of Finance (MoF) and plans to allocate an additional UZS 1 billion in 2007.** The Presidential Resolution of February 2005 established the Fund for Development of Mortgage Lending under the Ministry of Finance with the main focus on developing a subsidized housing finance program for low-income families. MoF is considering how best to use these funds to support mortgage market development. (See the Housing Subsidy section for more detail.)

44. **Given the official inflation rate of 8.3 percent, the planned 5 percent for a mortgage loan would result in an annualized loss of more than 3 percent in the value of the fund's assets and, as a result, its capital.** If inflation is running higher than 8.3 percent, as many observers believe, then the Fund's capital will erode all the more quickly. Beyond this inflationary erosion, it was not clear from interviews that the Fund's lending would be targeted to benefit households with the greatest need.

45. **As authorities are aware, there is no specification of mortgage lending in the prudential regulatory framework.** The Central Bank of Uzbekistan has standard rules for provisioning and capital rules in accordance with Basel I accords. The risk weight for mortgages is 100 percent, reflecting the uncertainty about foreclosure. The CBU does monitor maturity matching. Planned legislation for reforming the financial sector is to include the creation of a single registry for property transfers and for mortgage liens. As the system's mortgage portfolio grows, it will be necessary to review and provide guidance for the operational risks associated with mortgage lending particularly document quality and retention. As the government's action plan states, the authorities will look to the creation of a regulatory framework for mortgage default insurance and mortgage related securities issuance and investment.

Housing Affordability

46. **The cost of existing units is rising rapidly in Tashkent, and the limited supply that has been built recently is priced for upper income households.** A survey of apartment advertisements in Tashkent in 2006 showed that overall prices for existing apartments roughly doubled during the year. A lower cost 2 bedroom apartment with an average of 66 square meters of living area started the year at USD 12,000, or USD 179 per square meter, and ended at USD 22,000, or USD 303 per square meter.⁸ (See Table 2.)

Table 2

Average Sales Prices Tashkent, December, 2006		
At Dec, 2006 in USD	Apartment price	Price per square meter
Lower Cost Range	22,150	303
Moderate Cost Range	26,780	392
Upper Cost Range	52,650	676

Source: IFC Survey of advertised apartment prices

of an average unit with median household income, and they compare median monthly income to monthly mortgage payments on a median cost house. In general, housing is considered affordable when the median price is no more than 4 times median annual household income, and when a median household can finance a median priced house with a mortgage payment no greater than 30 percent of its monthly income.

48. **Data on median household income is not available for Uzbekistan, but average wage data is made public, permitting a rough estimate of affordability.** At the end of 2006 the average monthly wage was UZS 185,000, about USD 150, or USD 1,800 annually.⁹ The average USD price of 22,150 for a low cost apartment in Tashkent is 12.2 time the average annual salary.¹⁰ Given current financing terms from Ipoteka bank, the monthly payment for a low cost apartment would be 1.76 times the monthly average salary. Assuming two average incomes per household, the cost falls to 88 percent of monthly income, unaffordable by international standards. (See Table 3.)

⁸ Apartment prices in Tashkent are quoted in standards units, or U.S. dollars, in newspapers.

⁹ Speech of the President of Uzbekistan on February 12, 2007 at the meeting session of the Cabinet of Ministers discussing results of socio-economic development of the country in 2006 and setting key priorities for economic reforms in 2007

¹⁰ The difference between the median and the average can be large in measuring household incomes and house prices. The median is a much more dependable indicator of spending power of half the population, since a few very high incomes can produce an average wage that is much greater than the median. In this case, the fact that the average salary at January, 2007 was twice the salary reported at January, 2006 may reflect the growth of upper ranges more than the overall growth of all household incomes.

Table 3

Indicative Mortgage Payments Tashkent, December, 2006			
At Dec, 2006 in USD	Mortgage Payment*	Mortgage Payment/Average Wage**	Monthly Wage at Which Mortgage is Affordable
Lower Cost Range	265	1.76	1,058
Moderate Cost Range	320	4.85	1,280
Upper Cost Range	629	8.34	2,516

*Average monthly wage USD 150 at end 2006 per Uzbekistan government announcement.

**Assumes 10 year mortgage, 80% loan to value, 13% interest rate

49. **While data is limited, it shows that prices vary across the country for real estate, prices are generally rising, and prices in Tashkent are generally twice the level of prices reported in other locations.** In Tashkent, apartments in late 2006 ranged from \$300 per square meter to as high as \$1,500 per square meter in choice locations. Outside of Tashkent, prices are reported to be \$300-\$500 per square meter in late 2006, as compared with \$100-\$200 per square meter range in early 2005. Rather than completely reflecting labor or materials costs this difference is probably more a function of the higher land costs in Tashkent, the high income target audience for recent construction in the capital, and the prevalence of traditional self construction in rural areas. However, salaries are also lower outside of the capital. The average wage at January, 2006 in Samarkand was 54 percent of that paid in Tashkent, while that of Bukhara was 73 percent of Tashkent.

50. **Average construction costs are reported to be about \$47 per square meter in 2005 in Uzbekistan in general, and about \$89 per square meter in Tashkent.** This would be equivalent to \$6,110 for a two-story, 130 square meter house in Bukhara (presented as an example in interviews). In Tashkent, this would approximate \$6,536 for an average flat of 14.4 square meters per capita for a household of five. However, these costs are anecdotally-based and may be understated. In general, there has been a strong incentive to under-report values when registering properties. As such, many of the associated costs (e.g., labor, materials) may be omitted or under-represented. Likewise, they are likely to include only major direct costs (e.g., invoiced cost of materials and labor), without accounting for other costs.

51. **Many households have an endowment in the form of a privatized apartment that can be used to fund upgrades to larger units.** In the initial stages of developing the mortgage market, some of these households could be expected to finance small, short term mortgages at low LTVs should they wish to renovate or to upgrade to larger or more desirable apartments. This will be particularly appealing to upper income households.

The Growing Population and the Housing Stock

52. **Uzbekistan's population is young, rural and growing.** In 2003, 48.5 percent of household heads were aged less than 45, 58.7 percent of household heads were active in the workforce, there were an average of 3.1 adults of working age in each family, and 2.4 children.¹¹ According to official statistics, Uzbekistan is not urbanizing. The urban population's share of the total fell slightly over the past five years from 37.2 percent in 2001 to 36.1 percent in 2006.¹² The rural population growth rate in 2006 was close to three times that of urban areas. The overall population grew 7.3 percent from 2000 to early 2006, from 24.5 million to 26.3 million.

53. **The volume of new housing under construction has declined since 2003.** According to data from the State Statistics Committee, new housing under construction declined from 7.1 million square meters in 2001 to 6.0 million square meters in 2005. The number of new units under construction declined from 68,800 in 2002 to an average of 54,600 in 2004-05.¹³ Despite declines in new construction, the State Statistics Committee indicates that the total area of available housing has increased from 339.4 million square meters at year-end 2001 to 379.3 million square meters at the end of 2005, although the year-to-year annual increases do not reconcile with cumulative new additional space constructed since 2000. Of the existing housing stock figures at January 1, 2006, 308.6 million square meters were for free-standing houses, and 70.6 million square meters were for apartments.

54. **The construction of new housing units does not appear to meet the growth of the population.** At an average of 5 people per household, there were about 5.3 million households at the end of 2006. If the population maintains its five year average growth rate, Uzbekistan will add about 62,000 households in 2007, 36 percent of them in urban areas and 64 percent in rural. In addition to the shortfall in construction of new units, there were 179,266 families waiting to obtain land for home construction, and 86,537 officially-registered families waiting for apartments at the beginning of 2006. The numbers of families obtaining land for home construction in 2005 (32,948) is less than 20 percent of those still waiting.

55. **The average size of dwelling has remained fairly constant in recent years, and remains slightly larger than in 2000-01.** However, it is lower than targets set in the Government's Housing Code. The average dwelling has remained about the same size over the last several years at about 14.3-14.4 square meters per capita, an increase from 14 square meters per capita in 2001. It is the government's objective to increase the average dwelling size from an average of 14.4 square meters per person to 16 square meters by 2010.

¹¹ Source: Household Survey as reported in Uzbekistan Living Standards Assessment Update, World Bank, January, 2005

¹² Source: State Statistical Committee

¹³ Source State Statistics Committee as cited by IFC, includes both free-standing houses and apartments. "Central Asia Housing Finance Gap Analysis", IFC, September 2006,

56. **Issues of maintenance and condition persist in the nation's housing stock, reducing the value of residential real estate as a household asset.** Most the urban housing stock is made up of somewhat deteriorated or largely depreciated apartment blocks built in the 1970s and 1980s. While 98.6 percent of housing is privately owned, (including more than 90 percent of apartments that have been privatized since the 1990s) and fees for communal services cover most of their costs, responsibility for common spaces is not widely accepted by apartment unit owners. As a result, maintenance is poorly undertaken. Homeowner associations exist, but they are not well funded. As a result, the state has continued to provide deep subsidies for the cost of system upgrades (70 percent) in pre-1991 buildings through 2010. There is also a substantial stock of stand-alone units, especially in cities other than Tashkent, and in rural areas.

57. **Some maintenance issues have been addressed with the program to renovate flats built prior to 1991 and more generally to improve household access to critical infrastructure.** This has been in evidence with rising access of households to fresh drinking water, waste water treatment, and home heating. However, maintenance problems persist in some areas, including waste water treatment in rural areas and many older apartments and houses.

58. **Obsolescence of stock is determined by local authorities, and the determination has an impact on planning for new building and renovations.** In general, local communities have taken the lead in some cases with regard to apartments. These local committees conduct inspections (for example of roofing, walls, infrastructure connections, plumbing), and then compile a list of defects. The list of requirements is submitted to local governments that use these lists to set budgets for the upcoming year, as well as land allocation in the event that additional new housing is needed. Once the budget is developed, the local government procures contractors.

59. **There is rising investment in building materials, but it remains a small part of GDP.** Capital investment in building materials (mainly wall panels, cement, asbestos cement sheets, and ceramic tiles) has increased since 2000 on both a percentage-of-GDP and aggregate nominal basis, albeit slowing in 1Q 2006 and still remaining small as a share of total GDP at 1.1 percent in 2005. About 11 percent of the registered work force is employed in construction, housing and communal services, and building materials production/distribution.

60. **The construction sector is not well-developed as an industry.** Construction of large-scale commercial property has been financed by the state and carried out by foreign developers. Tashkent is reported to have two construction firms that build apartments for upper income segments of the population. Likewise, lenders in Bukhara report the existence of six local construction firms. Other secondary cities like Samarkand likewise have some firms that are active in the market. However, in terms of low-income or even middle-income households, most construction is reported to be informal. In rural areas and secondary towns, this may include the use of people who sell machinery and equipment and are in a position to operate them as well. However, many of these people are reported to be self-taught and have not gone through any formal vocational, apprenticing or licensing process.

61. To the extent that banks are making loans for housing construction outside of Tashkent, Ipoteka Bank appears to be the main player. However, volume has been low. Since 2000, Ipoteka bank has made about 70 loans in Bukhara (about 10-12 per year), 50 for existing structures and 20 for new. Average loan size in Bukhara approximated \$14,000 in late 2006, and the largest loan approximated \$25,000 at late 2006 exchange rates. Ipoteka (in Bukhara) mentioned that they disburse proceeds to firms carrying out construction, or to individuals if building is being done based on hashar. Disbursements are based on percentage of completion, subject to bank inspections for quality and completeness. Price increases for materials or construction costs are indexed, which can increase borrower risk.

Table 4: Housing Stock and Construction/Building Materials Data (2000-06)

	2000	2001	2002	2003	2004	2005	2006
GDP (billions \$)	\$13.5	\$11.5	\$9.7	\$10.1	\$12.0	\$13.7	\$16.1
o/w Construction/GDP	6.0%	5.8%	4.9%	4.5%	4.8%	4.9%	4.7%
o/w Construction (millions \$)	\$810	\$667	\$475	\$455	\$576	\$671	\$757
Capital Investment (billions \$)	\$2,209	\$2,577	\$2,059	\$2,037	\$2,580	\$2,879	\$2,114
o/w Construction/Capital Invest.	0.5%	0.6%	0.7%	0.7%	0.7%	0.9%	1.3%
o/w Construction (millions \$)	\$11	\$15	\$14	\$14	\$18	\$26	\$27
o/w Building Materials/Capital Invest.	0.3%	0.5%	0.5%	0.5%	0.6%	1.1%	0.8%
o/w Building Materials (millions \$)	\$6	\$12	\$11	\$10	\$16	\$33	\$16
Housing Stock							
Housing Stock (millions sq. meters)		339.4	360.9	365.6	373.5	379.3	
New Housing Construction (millions sq. meters)		7.1	7.6	6.8	6.2	6.0	
New Apartment Construction, thousands units		65.7	68.8	60.9	54.5	54.7	
Housing Stock Per Capita (sq. meters)	13.8	14.0	14.3	14.3	14.4	14.5	14.4
Connections to Central Water Supply	80.4%	81.4%	81.6%	81.8%	82.2%	83.8%	83.9%
Connections to Natural Gas	76.1%	77.2%	78.0%	79.8%	80.6%	81.0%	81.0%
Employment and Enterprise Data							
Employment in Construction						718,700	758,900
Employment in Housing/Communal Services						308,400	324,100
Small Enterprises in Construction						900	1,000
Micro-enterprises in Construction						9,700	11,400
<i>Notes: Construction data <u>not</u> specific to housing; Data for 2006 are 1Q and annualized when applicable</i>							
<i>Sources: State Statistics Committee, IMF, IFC, authors' calculations</i>							

The Policy Framework for Housing Markets and Housing Finance

62. **Uzbekistan continues to make important market-oriented reforms to the legal and regulatory framework for the housing sector.** These reforms have created several crucial elements of a market-driven housing finance delivery system. This includes private sector property developers, contractors, real estate professionals, appraisers, and lenders. Steps taken or in process include: (1) changes in the communal services system, such as legal assignment of responsibility for maintenance of common areas, and major improvements in the delivery of drinking water and heating; (2) the Law on Mortgage which establishes creditor and debtor rights and obligations; (3) modernization of the land cadastre and property registries in cooperation with EU-TACIS, which is important in establishing the value and identity of real estate as collateral for mortgage lending, and eventually establishing rapid and inexpensive processes for registering and transferring ownership rights and mortgage liens; (4) a law on property appraisals passed in 1999, complemented by regulations passed in 2003 that create standards for appraisal methodology; (5) a planned law on real estate activities, which has already been drafted and is eventually expected to facilitate development of a more liquid and transparent real estate market;¹⁴ and (6) the expected establishment of private freehold ownership of industrial land starting January 1, 2007, with privatization of residential land following on January 1, 2008.

63. **While the government's effort to develop the real estate market has included many important elements, much remains to be done.** The reform effort has focused on the use of market mechanisms with focused state interventions, an approach that has proved useful in many countries. It includes three sound elements: legal and regulatory support; strengthening of institutional capacity; and state actions to stimulate mortgage lending. The legal reforms to date address issues that have arisen with respect to collateral rights registration and mortgage foreclosure, but have not yet resolved the issue of foreclosure when the property is the primary residence. The state stimulation of mortgage crediting envisioned in the creation of the MLSF faces significant challenges due to relatively high inflation and interest rates (discusses under Real Estate Finance), the high cost of housing relative to wages (discussed under Housing Affordability) and the poorly developed construction industry (discussed under the Growing Population and the Housing Stock).

64. **Enforcement of the Law on Mortgage remains untested, and the ability to foreclose on defaulting borrowers is severely constrained.** The Law on Mortgage appears to be broadly satisfactory in defining a mortgage as a financial instrument and defining associated rights and obligations. However, it will be necessary to permit foreclosure on a primary residence. While foreclosure is the least desirable and most expensive means to enforce a mortgage contract, it is necessary to maintain it as a tool for lenders. The essence of a mortgage agreement is the promise of the borrower to either

14 Annex to the Resolution of the Cabinet of Ministers No.264 "On approval of legislative work of the Government of the Republic of Uzbekistan for 2007" dated December 22, 2006, Item#2 - Draft Law "On securities market" (introduction of a definition of a mortgage bond), Item#12 - Draft Law "On realtors' activities" (whole range of issues on regulating realtors' business) Item#14 - New Draft of the Land Code (range of measures related to introduction of private ownership on land)

pay the loan or give the house to the bank in settlement of the loan. If the bank legally unable to enforce its rights under the mortgage contract, then in practice, a mortgage contract was never really established.

65. **A weak or slow framework for foreclosure reduces the supply of mortgage credit and raises mortgage rates.** A weak framework for foreclosure creates several problems: (1) it serves as a deterrent for bankers to offer mortgages since the collateral lien contract is essentially unenforceable, (2) it increases interest rates on loans to compensate for risk, and (3) it invites moral hazard by providing easy conditions for borrowers to default on their obligations. Research in Europe and the United States shows that where foreclosure is rapid and certain, banks provide larger volumes of mortgage lending at lower rates of interest.¹⁵

66. **The recently adopted Law on Mortgage is silent on processes required to enforce a mortgage loan and evict a defaulting borrower.** In addition to the current elements of the law, the rights and obligations of defaulting borrowers and their lenders should be well-defined and should allow for a reasonable but limited opportunity to recover from short-term economic hardship. This may occur in law or in regulation. The form and timing of the bank's notification of default to the borrower, response to notification by the borrower, and ability to redeem the default should be defined in either regulation or law. Lenders should be given limited regulatory incentives to renegotiate the terms of loans to defaulting borrowers. Overall, lenders should be permitted to enforce the mortgage pledge and evict defaulting borrowers within one year. If the government considers it a policy imperative that alternative lodging is found for defaulting borrowers, the government should provide those housing units at its cost, rather than imposing the risk and cost on mortgage lenders.

67. **Transactions for new construction as well as on existing properties are made more vulnerable due to the absence of escrow accounts in the financial system.** An escrow account is a legal vehicle in which payments between two parties are held in trust by a licensed custodian, and thereby protected against the failure to adhere to contract terms by either party. Disbursements from the account are triggered by contractual agreement based on performance (for example, completion of new construction, signing of property sale and registration of mortgage lien for existing premises). The payment initially made by one party (for example the buyer) is proof of earnest intent to complete a purchase or pay for the construction of a property. Legislation usually requires strict adherence to fiduciary responsibilities by the custodian such that monies are held in cash or risk-free securities. Escrow regulations often require that a portion or all interest earned from the deposited payment are passed on to the party making the deposit into the

¹⁵ Jappelli, Tullio, Marco Pagano and Magda Bianco, "Courts and Banks: Effects of Judicial Enforcement on Credit Markets," April 2002, Dipartimento Di Scienze Economiche - Università Degli Studi Di Salerno; Clauretie, Terrence M and Thomas N Herzog "The Effect of State Foreclosure Laws on Loan Losses: Evidence from the Mortgage Insurance Industry," Journal of Money, Credit and Banking, 1990, vol. 22, issue 2, pages 221-33

escrow account, while the custodian is able to charge well-defined fees for its services and deduct the fee from interest earnings only (not the deposited principal). Such mechanisms protect prospective home buyers from builder default, particularly as many property developers seek to finance their projects from sales deposits.

68. **The residential rental market requires a reasonable balance between the rights of landlords and tenants.** While the mission was not able to explore the legal and regulatory framework for rental housing, it seems evident from discussions that there exists an active informal rental market. In every country, there is a significant portion of households that find it more convenient or economical to rent their home. In Western Europe and North America, as many as 35 percent of households rent their residences. Robust rental markets contribute to labor mobility by reducing the cost of relocation. Young families or individuals that have recently moved to cities may wish to rent until they settle permanently. Some low income households cannot afford the costs of ownership, particularly in cities and towns.

Housing Subsidies

69. **The government has not yet developed a detailed strategy for the provision and targeting of housing subsidies.** Such a strategy would include an analysis of household incomes in separate regions, the clear definition of intended beneficiary populations, an analysis of the shortcomings of the current system, and carefully-designed means to directly alleviate those shortcomings. There are a variety of commonly employed housing subsidy schemes, some more distortive and inefficient than others. (See table in Annex 3.) The few currently available housing assistance programs are fragmented, ad hoc, and often non-operational due to lack of funding and improper targeting mechanisms. In addition, the lack of reliable information and the inconsistent nature of housing assistance efforts on the part of the authorities make it impossible to provide any development impact assessment of existing initiatives on the ground (e.g. groups of low-income families/other beneficiaries who actually were able to improve living conditions).

70. **The government has abandoned the directly-funded building schemes that have led to serious losses in many countries.** During the period of 1996-2005 the Uzbek Housing Savings Bank (UJSB) disbursed over 6,500 housing loans, financed construction of 7,770 apartments across the country with total housing area of around 800,000 square meters. Total investment into housing construction facilitated by UJSB amounted to about UZS40.7 billion including UZS31.8 billion invested into social housing. The state budget provided around UZS15 billion to subsidize social housing construction and UJSB allocated UZS14 billion of its own resources. By 2003/2004, the Bank had gradually stopped providing housing loans due to a significant increase in housing construction costs, lack of sufficient funding, discontinued state budget subsidy allocations and increased hurdles in obtaining new land plots for housing development and construction. In 2005, the USJB was merged with Zamin bank and established as Ipoteka bank as the first in the country specialized mortgage lending bank.

71. **In 2005, as part of its efforts to establish a fully-fledged residential mortgage lending system, the government of Uzbekistan provided for a subsidized lending mechanism via a second tier institution.** Subsidized lending is to be facilitated through the Mortgage Lending Support Fund (MLSF) established in May 2005 under the Ministry of Finance (MoF). The MLSF would provide housing assistance to qualified individuals both for housing acquisition and construction. As of February, 2007, MLSF with support from Ipoteka Bank was still in the processes of establishing the internal operational procedures for various aspects of residential mortgage lending. Therefore, MLSF has not been able to open credit lines to Ipoteka Bank (and other banks respectively) to effectively start providing subsidized residential mortgage loans.

72. **The MLSF will provide lending on concessional terms to Ipoteka and other primary lenders for on lending to targeted populations.** The MLSF is tasked to (1) attract and accumulate long term loans, investment and grants from international financial institutions and from other sources; (2) open credit lines to Ipoteka Bank and other qualified banks for on-lending to individual borrowers to construct, renovate or purchase housing.

73. **MLSF is to be funded from a variety of sources.** Primarily from preferential long term loans, investment and grants of international financial institutions; public budget funds allocated under the Investment Program of the Republic of Uzbekistan; interest income earned on credit lines extended to local banks, income from investments of temporarily unallocated funds into short term treasury bills and securities as well as on bank deposits; and 50 percent of revenues from the auction sale of life-time possession rights (with hereditary succession) on land plots allocated for individual housing construction. Further, MLSF is permitted to raise funds through issuing mortgage and housing bonds and other securities.

74. **To date, MLSF has raised very limited amounts of funding.** As of December 31, 2006, MLSF's assets reached UZS3.9 billion including UZS3.5 billion provided from the state budget in the course of 2005-2006 and about UZS400 million from other sources (interest on deposits and allocations received from auction sale of life-time possession rights on land plots). In 2007, MLSF expects to receive additional UZS1 billion from the state budget under the State Investment Program. MLSF's total assets would support about 200 houses if it were to receive expected 2007 funds and each house were funded at the maximum loan amount.

75. **Ipoteka Bank and other qualified local banks can receive MLSF funding for further on-lending to individual borrowers under the following terms:**

- minimum 15 year term with three year grace period;
- annual interest rate not to exceed 5%;
- minimum 25% down-payment by borrower;

- Maximum loan amount: 2500 times the minimal wage¹⁶ for renovation of individual house or purchasing apartment; 3000 times the minimal wage for individual housing construction purposes.

76. **The loss embedded in the envisioned MLSF product will eventually lead to the same problems that the USJB suffered in directly subsidizing construction projects.** The real loss that results from the grace period and lending at a rate of interest less than the rate of inflation will erode the fund and require periodic replenishment from the government.

77. **The price limit set for the MLSF appears to be somewhat high in the context of regional house prices.** In current terms, it would translate to USD 25,000, somewhat higher than the USD 22,000 price of a low cost existing unit in Tashkent, and about the same as the price quoted for newly constructed units in Bukhara. Given the uncertain nature of reported household incomes, it makes sense to start with a lower value, and to consider varying the value according to regional prices.

78. **Rather than a maximum loan value, MLSF should consider a maximum property value.** A maximum loan value would permit higher income households to use the MLSF subsidized funding for low loan-to-value loans on higher value properties. Higher income households should be required to borrow at commercial market terms. A maximum property value would more effectively screen for higher income households, as lower cost properties would not be as attractive to upper income households.

79. **The MLSF product as currently considered will provide low cost, long term funding for a limited number of mortgages, but it will not create a marketable financial asset, nor will it lead to a sustainable lending market.** The below-market interest rate renders the loans ineligible to serve as collateral for mortgage bonds or other long-term funding. Rather than setting the rate ahead of time, it could be useful to review what is feasible for target families in separate regions. MLSF should consider separating the subsidy from the lending provided to make a house available.

80. **Other housing assistance programs are mostly small scale or one-off type of initiatives.** They include (1) the still existing but not functioning Soviet-era program whereby free housing is provided to qualified families based on adopted sanitary housing norms; (2) program aimed at supporting the construction of traditional individual owner-occupied housing; that provides for the theoretical possibility for qualified families to obtain free land plots from local authorities for individual housing construction purposes; (3) program whereby the common areas of apartment houses built pre-1991 to be renovated partly at public budget expense; (4) programs initiated and administered by provincial authorities (e.g. Bukhara program).

¹⁶ In accordance with the Decree of the President of the Republic of Uzbekistan No.3868 dated October 12, 2006, the minimal wage is set at UZS12,420 or around \$10 (in effect since November 1, 2006).

Land Markets

81. **The practical implementation of legal processes for access to undeveloped urban land is unclear, and no land appears to have been used in recent years to build low or moderate cost housing in major cities.** Urban land is legally defined, at least from work done during the Soviet period, and at best from more recent efforts, and each city has a plan that includes residential and industrial zoning. In Bukhara, city officials describe a broad five-year plan that includes parcels of land available for sale based on specifically determined needs of the city's population (e.g., free-standing housing, apartment complexes), which are updated annually. Some land allocation decisions are linked to national policies, such as assistance in housing, and land for employment-generating enterprises. In practice, no land appears to have been made available for moderate or low cost housing units in Tashkent, Bukhara, or Samarkand.

82. **Experience with land allocation processes is mixed.** On the one hand, land is said to be advertised via a local government procurement process. Land plots across the country have been auctioned via the Republican Real Estate Exchange (RREE), and cities designate parcels/lots that are available for development. Public announcements are made for projects to be financed, including sales of land for housing construction. In some cases, plots of land are made available for free on the condition that construction fulfills a stated purpose. In some cases, land plots are sold via auction. On the other hand, analysts have not been able to see the Tashkent city plan, nor has information been made available on the process for auctioning lots that have been made available for new construction in the past year. Informal interviews with developers reveal long delays in the permitting and allocation process, and a lack of clarity regarding the processes that adds to cost and risk.

83. **When land is made available for apartments, the developer faces uncertain costs and processes for all costs of lot preparation and infrastructure installation.** In practice, these costs dramatically reduce the incentive of the developer to build low or moderate cost units. Although the time allotted for all of the city's approval processes is limited to a matter of days by regulation, in fact the review periods may take several months, raising cost and risk for the developer. The Tashkent Khokimiyat charges a one time fee that apparently compensates the municipality for renovation and reconstruction works on main utility networks.¹⁷

84. **The lack of clear regulation with respect to land plot allocation for housing construction may lead to non-transparency and misconduct and hinder developers in identifying commercially viable opportunities.** The municipality of Tashkent has identified real estate in key urban areas that is devoted to obsolete structures or on which free-standing housing exists that will be demolished in favor of other uses, including commercial use and higher density housing. With Tashkent prices as high as \$1,500 per

¹⁷ Despite numerous requests the team was not able to get a copy of any internal document or normative act legally supporting the Khokimiyat's right to charge this fee. Nevertheless, during informal interviews with developers and number of Khokimiyat staff, the team were told that the fee is in fact charged, although no participant was able to explain on what grounds and how it is calculated.

square meter in high-income flats, there exists a substantial incentive for well connected developers to obtain such land for the construction of new high end housing. Uzbekistan is challenged by the apparent lack of transparency in the land procurement process combined with lack of legal recourse for existing home owners who could be forcibly evicted from their premises. In other markets such as Moscow, apartment owners have had their properties confiscated and have been relocated to outer ring settlements that are distant from their jobs and/or transport links, and significantly lower in value.

85. There is uncertainty about the adequacy of urban land supply in some of the largest cities, and of the capacity of the legal system to protect small holders from confiscation. The only aspect of allocation of land for housing construction that is clearly defined in the legislation is that which lists those state authorities responsible for the process. Land plots may be allocated for sale, lifetime rights or rent by the Cabinet of Ministers, or by the Khokims (heads of municipal authorities) of oblasts, Tashkent city, other cities, and rayons.¹⁸ The Khokim is required to set up a Standing Committee under the local state authority.¹⁹ With exception of basic functions, which are set out in the Land Code, the duties of the committee are under the discretion of the Khokim.

86. Any absence of adequate compensation and due process for existing occupants is unfair, and will retard the growth of housing market for all participants. The basis for any market is clearly enforceable contracts and reasonable compensation for takings or externalities. To the degree that small holders lose value in the process of developing urban land markets, all participants will fail to trust the system, and will act to

87. The procedures and methods for land allocation are not stipulated in legislation or regulation. The Land Code provides that land plots for individual housing construction are to be allocated to individuals on the basis of transfer of lifetime possession right with hereditary succession. A presidential decree²⁰ extended this provision to allow Khokimiyats to auction land plots of 0.06 hectares to individuals for housing construction. However, the legislation does not specify whether auction is the only mean of allocation, nor does it stipulates the legal rights to the land being auctioned to individuals or legal entities acquiring those rights.

88. Government measures over the last few years²¹ indicate that it tends to support the development of single-family home construction rather than apartment construction to meet the country-wide housing demand. This preference for single-family housing will be more successful in rural areas than urban. Single-family homes are financed from personal savings or informal loans (secured from relatives or friends), and usually built by temporary, unregistered groups of construction workers, typically to save

¹⁸ Article 23, Land Code of the Republic of Uzbekistan.

¹⁹ Article 34, Land Code of the Republic of Uzbekistan.

²⁰ Decree of the President of the Republic of Uzbekistan No.UP-1009 dated November 24, 1994.

²¹ Resolution of the President of the Republic of Uzbekistan No. PP-10 “On further developing housing construction and housing market” dated February 16, 2005. Resolution of the Cabinet of Ministers of the Republic of Uzbekistan No.272 “On approving Regulation on individual housing construction” dated December 30, 2006.

money.²² Professional developers are unable to compete on price, and therefore operate only in the relatively limited high-end apartment market.

89. **As of late 2006, large uncertainties remain regarding the upcoming change of the form of land ownership from leasehold to freehold, particularly with respect to the valuation of freehold rights.** The current system is based on poorly-defined leasehold usage rights. The government plans to convert to a freehold system for industrial land on January 1, 2007 and for residential land on January 1, 2008. Although this conversion will help to develop real estate markets, the transition will not be simple.

90. **There is no consensus within the government on how to determine the initial value of privatized lots in the absence of market quotes.** Moreover, as price quotes are not easily accessible, there is considerable room for distortion and a potential for corrupt behavior that ultimately retards market development. One possible solution is to use existing gray market quotes and newspaper prices for properties and subtract from them the Bureau for Technical Inventory (BTI) value of each structure. For instance, to value an apartment building, an analyst could sample prices quoted for units comparable to those in buildings in the same neighborhood. The land on which the building stands would then be valued as the sum of the value of the separate apartments less the BTI value, less depreciation. As the market develops and transactions are more accurately recorded and made public, movement to market prices will eventually predominate.

91. **The issue of land valuation will be important for residential property owners, particularly if these assets become the subject of higher municipal taxation.** On the one hand, residential property (land plus premises) constitutes a major asset for households. On the other hand, rising values become a basis for higher taxes applied by local governments in exchange for services rendered. Methods of assessing properties for municipal (or other) taxes will be subject to a number of considerations, not the least of which is potentially excessive pricing for tax purposes without adequate recourse on the part of home owners to appeals that would protect them against rapidly rising taxes. As land and property valuation issues are addressed, it will be important to account for the ability of households to pay valuation-based property taxes.

²² Especially in rural areas, single-family homes are commonly built by “khashar”, that is, by the owners themselves with help from close relatives and neighbours.

Real Estate Markets

92. **Real estate markets are opaque and underdeveloped, increasing risks and costs for all participants.** Real estate brokers and appraisers work primarily for large commercial interests. The formal rental sector is largely limited to the expatriate community. Most individuals personally negotiate prices and settle transactions in cash at their own risk.

93. **Transaction costs such as for title transfer are relatively low, but are not clearly disclosed, and processing time is excessively long, raising risk for participants and for would-be mortgage lenders and limiting the growth of the mortgage market.** There is a liquid market in Tashkent and other cities for direct sale of residences via newspaper advertisements and by word of mouth. Transactions are reportedly settled in cash, which is risky for both buyers and sellers. Each purchase and sale involves as many as 13 steps with total costs approximating USD 100-equivalent, and taking over a month. (See Annex 1 for details for 2005. Estimates in 2006 assumed reduced amounts paid to Notaries, reduced average wait times for BTI processing, and an average household of five.) It takes 30 days to register the mortgage pledge, an unwarranted delay that adds uncertainty to the lending bank. This protracted processing period limits the value of the residential property as collateral for a mortgage loan because the lender is not able to clearly ascertain ownership. Should the borrower default during this transfer period, the lender may have no rights to the collateral property. As a result, so long as the process is uncertain, lenders will be reluctant to provide mortgages, especially for low and moderate cost housing.

94. **Land and building registries are being modernized, but processes for the registration of transactions remain opaque.** Anecdotal reports of time to register and transfer property rights are short, notwithstanding earlier reports that showed the registration of title transfer on property took as long as 30 days. Even though the Law on Mortgage requires simultaneous registration of mortgage liens and ownership rights there is said to be an estimated five or so days between the registration of title transfer and the registration of a mortgage agreement.²³ This discourages banks from disbursing funds until the mortgage agreement is signed (adding more delays to the process and potentially allowing a transaction to not be definitively closed), and puts the bank at risk that issues may emerge that jeopardize the quality of the credit. As an example, physical damage to the property during the gap between sale and registration could reduce its value, reducing the willingness of the bank to disburse funds by the agreed amount. In well functioning housing finance systems, transactions and liens are registered simultaneously to avert the risks associated with such gaps.

95. **The role of professional realtors is limited to high-end location services for foreign investors, and one-off brokers who may do this as a supplement to other employment.** In general, the realty industry is not organized, although at least one company earlier tried to organize other companies into a realty association to play a

²³ The Program document also notes the importance of eliminating this gap.

modest role in certifying professionals and providing basic market information. There is no formal professional training or certification program.

96. **There are many real estate agencies, and they tend to focus on private individuals, not companies.** Listings are available from three major newspapers, directories and web sites. However, there is no multiple listing service. Real estate agencies charge 3 percent sales fees, although these are negotiable. Their services include (1) facilitating all the bureaucratic formalities of the sale, (2) bringing buyers and sellers together, and (3) managing rental contracts.

97. **An appraisal industry exists, with licensed appraisers apparently providing their services according to international norms at reasonable cost.** Appraisers operate under a 1999 law, a 2003 regulation on licensing, and a 2006 regulation on standards for appraised values that apparently are in accordance with international norms. Voluntary licensing standards for appraisers are little used. Most appraisers work for either the government, banks, or for private firms. In all, about 270 entities are licensed to provide appraisals, of which 100 are in Tashkent. Very few are independent. The maximum appraisal fee is \$150, and more normally the charge is \$100. Banks routinely reduce outside appraisals by 20-30 percent before assigning values that can be used to help determine loan size. Given the limited dissemination of market information and incentives for those involved to under-report transaction value, such discounting is not surprising.

98. **There is a market mechanism for organized property sales via the Republican Real Estate Exchange (RREE), mainly for divestiture of state properties.** This is an electronic exchange with regional branches that trades three times per week, along with regularly scheduled auctions. Most of the activity is related to agricultural assets and properties, such as farms and livestock shelter. However, this market has also been used to sell state-owned land plots intended for home construction, as well as existing residential and non-residential properties. The total value of properties sold on the RREE in 2005 approximated \$39 million, of which about \$12.8 million was for premises (residential and non-residential) and less than \$0.6 million was for land plots.

Table 3: Volume and Value of Transactions on the Republican Real Estate Exchange

	2000	2001	2002	2003	2004	2005	2006
Total Value in \$ Thousands							
Construction in Progress	\$1,869	\$1,091	\$1,122	\$1,211	\$1,422	\$1,660	\$1,834
Commercial and Consumer Services	\$1,335	\$2,383	\$1,402	\$3,299	\$8,726	\$14,706	\$15,385
Agriculture and Water	\$1,335	\$716	\$534	\$673	\$4,294	\$10,331	\$25,801
Land Plots	\$754	\$983	\$743	\$505	\$606	\$555	\$402
Housing and Other Premises	\$13,045	\$18,925	\$18,014	\$18,474	\$12,701	\$12,800	\$12,707
Total	18,338	24,098	21,816	24,161	27,750	40,052	56,129
Actual Number of Units Sold							
Construction in Progress	296	265	180	586	896	1,087	928
Commercial and Consumer Services	419	548	436	954	1,768	2,025	2,432
Agriculture and Water	602	510	413	904	2,516	8,164	14,244
Land Plots	5,700	8,662	8,335	7,391	6,296	5,221	3,560
Housing and Other Premises	1,926	5,231	4,920	4,078	3,123	4,435	6,328
Total	8,943	15,216	14,284	13,913	14,599	20,932	27,492
Actual \$ Value on Average							
Construction in Progress	\$6,316	\$4,116	\$6,236	\$2,067	\$1,587	\$1,527	\$1,976
Commercial and Consumer Services	\$3,187	\$4,348	\$3,215	\$3,458	\$4,936	\$7,262	\$6,326
Agriculture and Water	\$2,218	\$1,404	\$1,294	\$744	\$1,707	\$1,265	\$1,811
Land Plots	\$132	\$114	\$89	\$68	\$96	\$106	\$113
Housing and Other Premises	\$6,773	\$3,618	\$3,661	\$4,530	\$4,067	\$2,886	\$2,008
Average (applied to Totals)	\$2,051	\$1,584	\$1,527	\$1,737	\$1,901	\$1,913	\$2,042
<i>Notes: Data from 1Q 2006 are annualized; 2006 exchange rate is from September 30, 2006</i>							
<i>Source: Republican Real Estate Exchange; authors' calculations</i>							

Annex 1: Steps Required to Sell an Apartment in Tashkent as of 2005

1. Certificate from the State Property Committee. Needed only if the apartment has not yet been sold after the privatization from state ownership. It takes up to two months to obtain this certificate from the date of application. Official fee is about 35,000 soum. This certificate is effective for one month from the date of issue.
2. Certificate from the *Teplokommunenergo* (district communal heating company). This certificate is effective for two weeks from the date of issue, it takes up to one day to issue it, and the official fee is about 500 soum.
3. Certificate from the *Vodokanal* (district water supply company). This certificate is effective for two weeks from the date of issue, it takes up to one day to issue it, and the official fee is about 500 soum.
4. Certificate from the *Raygaz* (district gas supply company). This certificate is effective for two weeks from the date of issue, it takes up to one day to issue it, and the official fee is about 500 soum.
5. Certificate from the *RES* (district electricity supply company). The owner should apply to the company 2-3 days in advance of needing this certificate. An inspector reviews the apartment's metering devise and informs the *RES office*. This certificate is effective for one week from the date of issue, it takes about 2-3 days after inspector's visit to issue it, and the official fee is about 1000 soum.
6. Certificate from the *Passportistka* (citizens' passport registry office under local district authorities) on the number of people registered in the apartment. This certificate is effective for one week from the date of issue, it takes up to one day to issue it, and the official fee is about 500 soum.
7. Certificate from the *TSZh* (household owners association) on arrears for monthly maintenance payments. This certificate is effective for one week from the date of issue, it takes up to one day to issue it, and the official fee is about 200 soum.
8. Certificate from the local tax authorities on arrears for payments of the land tax. This certificate is effective for one month from the date of issue, it takes a couple of hours to issue it, and the official fee is about 500 soum.
9. Certificate from the *ATS* (fixed line telephone company) on arrears for payments of the telephone charges. This certificate is effective for one week from the date of issue, it takes one hour to issue it, and the official fee is about 200 soum.
10. Certificate from the *Bureau for Technical Inventory (BTI)* that states the permission to sell this apartment. To apply for that certificate, the owner should collect all nine above mentioned certificates, bring photocopies of these certificates to BTI, plus bring the technical scheme of the apartment, plus the application. This certificate is effective for one month from the date of issue, it takes from one week to one month to get it, and the official fee depends on how urgent the owners needs it issued - from 5000 soum (if issued in one month) to 7000 soum (if issued in two weeks), and 15000 soum (if issued in one week).
11. After obtaining the certificate from BTI, the owner is able to legally formalize the sell and purchase contract of the apartment in the Notary office. The owner should bring to Notary office the originals of all nine above mentioned certificates, and all registered people in the apartment must also be present in the Notary and certify that they have no objection to the sell of apartment. The notary has the templates of such contracts and the registration takes about an hour and the notary fee was about 10 percent of the nominal state value of the apartment by BTI. This fee is dependent mainly from the year of construction and total square meters of the apartment, and ranges from 100000 to 500000 soum. This fee can be paid by either seller or buyer, or shared between seller and buyer according to their bilateral agreement. The old owner has the right and may require up to one month moving out of the sold apartment.
12. After Notary registration of the sell and purchase contract, the new owner of the apartment should register herself and members of the family with the *Passportistka* (citizens' passport registry office under local district authorities). After registration the new owner receives the certificate on the number of registered people in the apartment. It takes up to two weeks to register and the official fee is about 3000 soum per person.
13. After Notary registration of the sell and purchase contract and registering with the citizens' passport registry office under local district authorities, the new owner of the apartment should make copies of the sell and purchase contract and of the certificate on the number of registered people in the apartment. After that new owner should bring to each of the agencies mentioned above in first 9 steps,

and leave to each agency a copy of the sell and purchase contract and the certificate on the number of registered people in the apartment. Each agency will then re-write the accounting documents to the name of new owner. This step does not require paying any fee to any agency.

Note: Official fees at first 9 steps are normally not publicly available and it is up to each agency to establish a fee to the apartment owner. Each agency mentioned in the first 9 steps has normally required a double fee to accelerate the process of receiving any of the above certificates.

Annex 2. Housing Subsidy Themes from International Experience

Well designed housing subsidies are efficient in that they reach people who otherwise lack the capacity to buy or rent a decent apartment or house. Likewise, well designed subsidies are horizontally equitable in that they provide the same amount of subsidy to every member of a given class of households.

Countries frequently subsidize the middle and upper income segments even though they can afford to buy without a subsidy. When the middle class provides the bulk of the tax resources, subsidies to the middle class will reduce economic growth prospects of the society by requiring higher taxes without social benefit. Moreover, common demand-oriented subsidies typically benefit disproportionately the upper middle income segment, creating negative social equity effects.²⁴

Steps to consider in developing a housing policy and subsidy program:

- **Determine policy goals.** Analyze the housing and mortgage finance system to reveal shortcomings and their causes. Identify target population groups such as by income level. Establish the need for a subsidy for specific segments of the market and goals for the subsidy, such as to enable moderate income households to buy housing units, to enable low income households to rent acceptable quality housing units, or to enable low income households to renovate apartments that they acquired through privatization.

Analysts should distinguish problems that can be corrected through regulatory or policy reform from those at the macroeconomic level. Regulatory and legal obstacles include excessive costs of obtaining developable land or permits and legal obstacles to enforcement of the mortgage lien. Macro-economic obstacles include high inflation that produces interest rates too high to sustain long term finance. Subsidies will not lead to the development of the market if primary conditions such as the legal framework are seriously lacking.

- **Select the best intervention.** With target populations and goals identified, policy makers can outline subsidy options, taking into account the most appropriate point of intervention (e.g., with individuals or with lenders) and select the best implementation agents based on agreed upon design principles. Critical here is tailoring solutions to the capacities of the country's institutions. Countries with relatively well-developed banking sectors can better gauge the costs to bankers of lending to moderate and lower income households. Overall, the simplest subsidies provide resources directly to the targeted household.
- **Costing and budgeting.** Cost estimates and program design should take into account all current and future costs to reach the goals established in the country's housing policy. Costs should be compared to individual and social benefits, and

²⁴ This section draws from Diamond, Douglas, "Thinking about Subsidies to Housing Finance," mimeo, 2004.

fairness considerations. Transparency should be considered as an element in evaluating alternatives.

Costing of the subsidy is particularly important. If the real costs are not calculated, the political system will much more heavily weigh the near term impacts on the budget than the long-term ones, especially if the long-term ones are due to such things as risks that can be conveniently downplayed. The result will be a subsidy scheme that is either unsustainable or more expensive than expected.

- **Implementing and monitoring.** Even the best designed subsidy with adequate funding can fail to be efficient and effective if it is not implemented properly. Moreover, it can fail to be politically successful if the procedures and results of the scheme are not publicized and monitored sufficiently to ensure recognition for what it can and cannot do. Finally, and unfortunately very rarely, existing subsidies should be evaluated over time for effectiveness and efficiency and needed refinements (e.g., in targeting or depth of subsidy). This last step is actually the key to moving gradually to a rationalized subsidy policy, since even rudimentary analysis can make it (embarrassingly) clear that some schemes have little net effect relative to their cost or are badly targeted.

Housing Policy With Clear Goals

Many governments have moved to a policy framework that makes greater use of the private sector to deliver goods and services instead of expecting the state to build and maintain housing. Such policies expect upper and middle income households to pay for their own needs in the market. If banks require it, the government may provide incentives to the private sector for limited periods of time to encourage lending to moderate income segments. **The government provides deeper subsidies for the lowest income segments, but in cooperation with the private sector where possible.**

Policy Example: Colombia

In January of 2006, the Colombian government promulgated its *Ciudades Amables* (Friendly Cities) strategy, in which it sets as a goal the complete elimination of slums by the year 2019. To do this, it has mapped out a series of interventions in the market for urban land, the city and regional planning process, the provision of urban services, the costs of constructing affordable housing, and the provision of financing to moderate and low income people. The government is tailoring implicit and explicit subsidies to several links in the value chain of the provision of housing, including coordination of regional land use plans, acquisition of urban land for low income housing, exemptions from value-added tax on materials for builders of low income housing, down payment subsidies for low and moderate income borrowers, provision of long term funding by government funds, and tax incentives for investors in bonds backed by mortgages on low-income houses. While the goal of complete slum eradication may be too ambitious, its expression provides a framework for costing and budgeting funds for the effort, and Colombia plans to devote substantial resources to the implementation of the strategy.

Policy Example: Chile

In Chile in the 1960s and 1970s, public agencies were directly involved in every step of the development of low income housing, from the acquisition of urban land to the design, construction and final sale of the housing units. The system was regressive: the higher the cost of the house, the higher the subsidy. Finished houses required large investments by government. As a result, only a fraction of household demand was satisfied. The resulting product was unaffordable for the poor. The system failed to generate market incentives, and was largely inefficient, with serious losses to waste and corruption. Informal slum settlements grew rapidly.

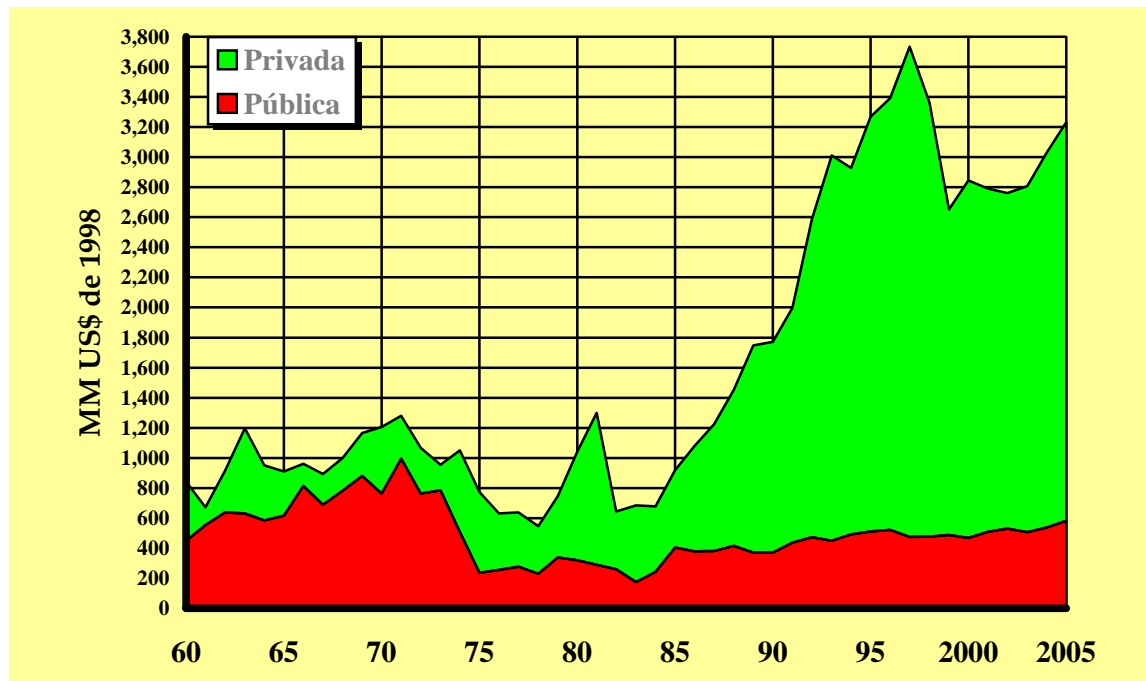
Since 1978, the Chilean government has gradually withdrawn from each of the steps in developing low-cost housing until now, it provides subsidies to end buyers in the form of down payment assistance, and it coordinates private and public sector actors for redevelopment of run down city neighbourhoods.²⁵ Private developers do all the rest.

The Chilean policy has been successful in terms of attracting private investment and producing housing units.²⁶ Substantial funding has been required to achieve this success. Chile's budget for down payment subsidies peaked at 3.2 percent of GDP in 1985, and since has been in the range of 0.7 to 1.0 percent of GDP. However, in real terms, public investment in housing is now 40 percent less than it was in the 1970s, when state directly funded construction. Meanwhile, private investment has grown by seven times over the same period. (See Graph 1.) Housing production has exceeded household growth since the early 1990s. Although Chile has persistent challenges in low income housing, it has substantially reduced its housing deficit and improved the living standards of millions of households.

²⁵ Chile's housing ministry continued until 2002 to offer loans with subsidized interest rates to low income buyers. This program suffered from high default rates and financial losses.

²⁶ It should be noted that issues persist with the quality of some of the low income housing developments. The government has struggled to maintain standards for green space and community amenities.

Graph 1 Private and Public Investment in Housing in Chile 1960 - 2005



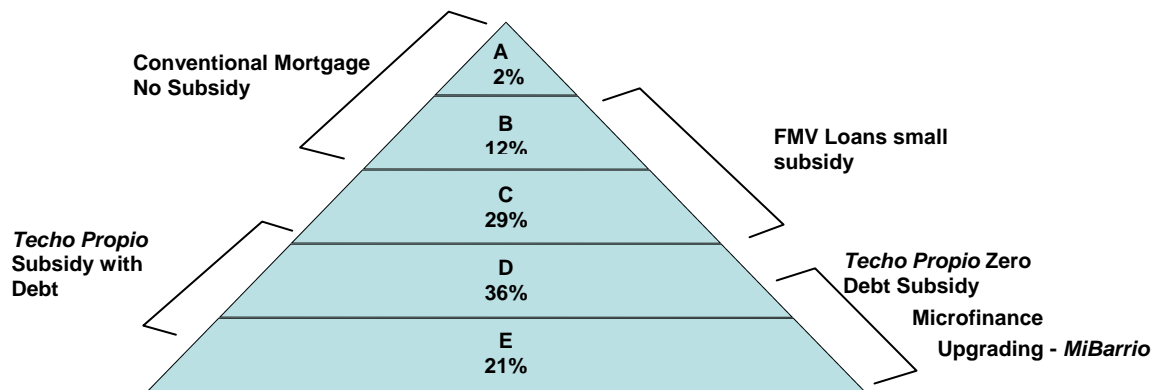
Source: Chilean Chamber of Construction

In the graph, green represents private investment, red is public. Vertical axis represents billions of 1998 U.S. dollars.

Policy Example: Peru

Peru created a single government entity responsible for housing policy in 2002 and established a National Housing Strategy for the years 2003-07. The policy laid the groundwork for broad-based institutional and policy change in the housing sector. Prior to these developments there was little coordination among key institutions on housing and urban development policy issues. Figure 1 below outlines the range of sector programs targeting different income groups. In the figure, A is the highest segment of the income distribution, earning more than USD 3,300 monthly, and E is the lowest, earning less than USD 123 monthly. The percents in the pyramid segments represent the portion of the population in that segment. So, 2 percent of the population are in highest earning segment A, while 21 percent are in the lowest, segment E.

Figure 1: Peruvian Housing Solutions by Income Segment



The Peruvian strategy expects the private sector to serve segment A. Some limited subsidies and incentives have been required to draw banks to serve segments B and C. Segments D and E are likely to require deeper subsidies. Lower earners in segment E are not able to afford a long-term mortgage, as their income is too low and unstable.

The government created Fondo MiVivienda (FMV) as a stand-alone fund in 1999 to promote housing lending. FMV marked a shift in public policies from the direct provision of housing and mortgages for middle income families to enabling and facilitating the private sector and focusing increasingly on low-income families. FMV has two main programs – a credit-linked subsidy and mortgage insurance. The credit-linked subsidy serves as an incentive for private financial institutions to offer mortgages for the purchase of homes priced between USD 12,000 and USD 50,000 - targeting primarily middle-income families (segments B and C in the figure). FMV loans were responsible for 40 percent of the growth in the Peruvian mortgage market between 2000 and 2005.

The Government has also launched a parallel direct demand subsidy program – Techo Propio – targeting low-income households with solutions ranging from USD 4,000 to USD 8,000 (segments D and E). The program delivers a direct demand subsidy to families who complement this subsidy with their down-payment and where necessary a loan for the purchase of a new home, construction or rehabilitation.

What to Subsidize?

Market Information

A natural aspect of market development for the government to support is the provision of information as a public good that leads to greater efficiency and competition. This can also be quite inexpensive, especially in comparison to demand subsidies. Competition within the sector leads to lower prices and greater supply. Central banks and housing ministries in many countries gather and publicize data on financial market prices and business volumes, real estate transaction prices, construction costs and technology, and the state of the housing stock. Governments publicize both reported

prices from property registries and results of surveys of individuals and of publicized prices. Governments in the United States, Colombia, and Mexico have developed or are developing repeat sales price indexes that track the evolution of prices for specific properties. The Bank of Spain regularly produces statistics on property prices and mortgage rates, and it produces periodic studies on market developments. Central banks in Europe? U.S. Census of Housing, India? Malaysia?)

Strengthening the Banking Sector

Governments foster the growth of strong and competitive banking sector through regulation and through the provision of liquidity funds and mortgage default insurance that mitigates credit risk. Prudential regulatory norms call for risk-based pricing, reserves, and capital. Financial reporting norms promote transparency.

Direct Public Lenders

The government may reduce the cost of credit by bypassing banks and offering low-interest rate loans directly to households. Direct lending by the government was the primary mode for supporting housing finance in many countries in the 1960s and 1970s, and persisted in some through the 1990s. In only a few notable cases have direct public lenders performed well. One successful case is the Government Housing Bank of Thailand which prices its loans at market and has kept defaults to a sustainable level, even during the Asian crisis of 1998.

Direct government lending has generally been a costly failure in developing housing markets. Public lenders face enormous political pressures to price below market, to permit loose underwriting conditions, and to forbear on defaulting borrowers. When loans are priced below market, they reduce the earnings power of the institution and its financial strength and sustainability. Institutions that permit high default rates fail or require periodic and indeterminate government bailouts. Experience in many countries shows that the public views a discounted financial product as less valuable than one that carries a market price. This lack of appreciation for the product can lead to a greater willingness to default, particularly to public lenders.

One recent illustrative case the risks of public lenders is Banco Hipotecario del Uruguay, or BHU, which was created by the Uruguayan government to foster a mortgage market for moderate income households. BHU's failure in 2002 points out some of the risks inherent in inflation indexed lending, sub-market pricing, weak collections, and poor targeting of subsidies. BHU was responsible for about 90 percent of housing loans originated in Uruguay in the 1980s and 1990s. BHU offered mortgage loans denominated in an inflation index linked to real wages. In practice, this index was allowed to depreciate relative to real wages, eroding the value of the outstanding debt and weakening the bank. Moreover, the rate charged on BHU loans was below market—the spread over the index in 2006 was 7 percent on a BHU loan, versus 9 and 12 percent charged by private banks. Finally, BHU's lax collection practices provided an implicit subsidy to borrowers. BHU became insolvent and its activities were sharply reduced in 2002. As late as 2006, an estimated 68 percent of BHU's mortgage loans were in default.

BHU borrowers can afford to pay their mortgages; many earn salaries just below the top 20 percent of the income distribution. However, with easy terms on BHU loans, borrowers had no interest in private mortgage loans, nor were private lenders interested in offering mortgages. As a result, even after all of the government's expenditures for BHU, the Uruguayan mortgage market remains underdeveloped.

Government Secondary Lenders

A more successful model for government banks is to be a secondary or wholesale lender that lends to commercial banks rather than lending directly to consumers.

The subsidy element of such a lender may consist of the mere presence of long term lines of credit, or it may extend to discounts on the cost of long term funding. A secondary lender may act as a liquidity facility, providing long term funding to commercial primary lenders but leaving credit risk at the level of the primary lender. Thus, the government reduces the market risk of the primary lender while maintaining the incentive and responsibility of the primary lender to underwrite the loans well and to collect them fully.

There are a host of successful secondary mortgage lenders, including National Housing Bank in India, Cagamas in Malaysia (www.cagamas.com.my), Fondo MiVivenda in Peru, Sociedad Hipotecaria Federal in Mexico, and the Federal Home Loan Banks in the United States.

Interest rate subsidy or buy-down through private lenders

Interest rate subsidies to private lenders to fund the issuance of mortgages are difficult to design and target effectively. The risk of interest rate subsidies is that they promote demand for housing finance by upper income groups (rather than increasing general housing consumption), which distorts financial markets. The short term advantage of interest rate subsidies is that they typically are not recorded on the government's budget, and since they often go to upper middle class borrowers, they are politically popular. The risk is that once established, their political popularity will prevent the government from reforming them in favour of more efficient and equitable subsidies. They are frequently designed in such a way that they are regressive and very costly, but they can, in principle, be designed to be reasonable targeted, transparent, and efficient.

Two recent examples of relatively well-designed interest rate buy downs have been instituted in Poland and Jordan. In each case, mortgage interest rates and loan terms are determined in the market and reflect the costs and risks of doing business. The interest rate buy down program is calibrated to act for just the amount of time required to get lower income households into a home. Poland's subsidy acts only during first 8 years of the life of the credit. It can be used only for modestly-sized apartments, up to maximum of 50-60 square meters. It permits a lower loan-to-value ratio and a lower debt-to-income ratio.

Up-Front Subsidies

The simplest, most efficient general household subsidy to boost demand, and the least distortive and regressive, is a non-refundable upfront grant to first-time home-

owners. Upfront grants can be designed so as to decrease with the price of the house, to be minimal at the upper middle income levels and in order to avoid a “cliff effect,” whereby a small change in income or house value may qualify or disqualify a borrower. In transition economies such subsidies may be designed to improve an existing house both for resident owners or first-time homeowners.

For a moderate income household, an up-front subsidy may be coupled with a small borrower down payment and a market rate mortgage that is tailored to the household's monthly income. The low down payment maintains the household's interest in paying the loan, but relieves it of a difficult savings requirement. The resulting loan is a valuable asset for the lender, the interest payment of which allows it to build required reserves and capital that ensure its stability.

Chile, as discussed above, has used up-front subsidies more consistently and aggressively than many countries and has developed a substantial private industry for the provision of housing for low and moderate-income households. Due to rapid population growth, the program was oriented towards the purchase of new units. Under its Basic Housing program in the 1990s, the individual would make a down payment of as little as 3 percent, the government would provide a cash subsidy ranging from between 6 percent and 27 percent, and a private bank would provide a market rate mortgage for the balance of the purchase price.

Subsidizing Origination Costs

Financial institutions work best at large scale – large numbers of large volume transactions permit institutions to more completely take advantage of people and automated systems. As a result, the extension of credit to low income borrowers can cost more for the lender than the extension of credit to upper income borrowers. Loan balances are smaller for low income borrowers, but the operational costs are the same or higher than for an upper income borrower with a large loan. It may take more time, effort, and documentation to verify a more volatile or informal income.

One way to encourage lenders to move down market is to provide a cash subsidy to the lender to compensate for extra costs. The Chilean government provides a fixed amount between \$100 and \$300 to the lending bank for each loan to finance a subsidized house of less than \$17,000. Further, the ministry of housing guarantees the loan will be sold in the secondary market at 100 percent of its value (if not, the ministry pays the difference). Finally, the government sells lenders mortgage default insurance to protect them from loss in case of default.

Closed Contract Savings Systems

“Closed” savings and loan systems known as contract savings for housing (CSH), involve subsidies for savings and below-market rates for loans. The CSH system often referred to as ‘building savings’ or ‘housing savings’ system, was introduced in

several transition economies, including Slovakia, the Czech Republic, and Hungary in the 1990s. These schemes generally are copies of the Austrian and German ‘Bausparen.’²⁷

In closed CSH systems, the CSH institutions may only make housing mortgage loans using deposits that they attract from the public. The system is closed in that no other form of funding is possible and no other form of lending. As a result, CSH lenders cannot benefit from diversification of credit risk. The individual contracts to save for a specified time period and amount and upon completion of the savings period are eligible for a mortgage loan. Since the availability of funds for loans is a function of the volume of deposits, CSH institutions frequently require a waiting period for loans to be made even after the savings period is complete. The institution provides for both the savings account and the eventual loan at below-market rates of interest. To encourage growth of the system, many countries have subsidized the savings interest rate with a government-funded premium.

Contract savings accounts can be useful, particularly as a means to develop a record of financial responsibility for low income households, however, CHS presents complex design challenges and in many cases the savings premiums have not produced many new houses. CSH can be a useful tool for the early stage of the development of a housing finance system because it fosters a savings and housing lending. When poorly structured, CSH systems provide substantial savings subsidies for upper income households without producing many housing units. In practice, it has proven difficult to develop CSH systems without subsidies.

Issues with the closed CSH system arise with: pricing of savings and lending components; liquidity management (with contractual deposits the only source of funding, the institutions lack flexibility in managing liabilities); indeterminate waiting period for the loan; and possible capture of savings subsidies by upper income households that fail to take out mortgages.

In the Czech example, the premium offered on savings was originally set at 25% of annual savings up to a level of CZK 4,500. Multiple contracts per family were possible, as was roll-over of the unexploited difference between the maximum premium and the actual premium paid to subsequent year(s). The net effect of the premium was to produce a yield on savings three times the market yield on bank deposits. However, lending was limited, producing loans for only 28 percent of savings balances by 2002. As a result, the government’s premium budget of 0.49 percent of GDP failed to produce many housing units. On the other hand, a better premium and product structure in Slovakia produced loans of close to 100 percent in return for a premium budget of 0.28 percent of GDP.

Given the possibility of multiple accounts per family and the lack of means testing, it can be concluded that the savings subsidy was inefficient, in that a substantial portion of savings premiums in each of the Czech and Slovak cases went to households that would

²⁷ The account of the Czech and Slovakian CSH systems are drawn from Hans-Joachim Dübel, “Contract Savings for Housing (CSH) in Transition Countries – the Cases of Czech Republic and Slovakia,” mimeo, June, 2003.

have been able to save and buy a home without help from the government.²⁸ The savings subsidy fails the horizontal equity test, in that households in similar conditions may receive varying savings premiums.

CSH is not convenient to address many of the typical problems of the housing stock in transition countries. For example, neither in Slovakia nor the Czech Republic is CSH loans used systematically to provide finance for common areas (roof, elevator, structural repairs). Finally, the large public expenditures on savings premiums have left few resources for more efficient and equitable subsidies.

Expanding Private Rental Markets

Many households find it inconvenient or excessively expensive to buy, for example, young families, individuals that have recently moved to a city, some retirees, and very low income households. In their rapid push to privatize, transition countries have broadly ignored the need for rental housing markets.²⁹ More transition countries are considering a framework and incentives to encourage institutional investment in moderate cost rental housing. For low-income households, they are considering efficient, well-targeted subsidy schemes.

The legal and regulatory framework for rental markets should balance the rights of tenants and landlords to protect each, while providing an incentive for the private sector to invest. There should be clarity in law and regulation regarding the rights of tenants to decent, safe, and sanitary housing, and for landlords to evict a non-paying tenant in a reasonably short time period.

The government may provide cash grants, interest rate buy-downs or even tax subsidies to investors to lower the capital investment costs and hence the ultimate rents paid by the consumer. Local governments may make urban land available at a low cost as a subsidy for private contractors that build low-income housing. Production of rental housing may be from either private landlords or non-profit housing associations.

In most European countries, monthly housing allowance subsidies (household subsidies) to renters are required to make low-cost projects financially feasible. A way to further improve the housing choice of tenants, and obtain the efficiencies of private provision of rental housing, is to provide households with a housing voucher that can be used for partial payment of rent for a private rental unit of their choice. But to be effective, housing vouchers require well developed rental markets. There has to be an adequate supply for the voucher system to work. Quality control on the type of unit the beneficiary of a voucher will select is difficult to conduct. However, housing allowance schemes can be very useful in managing the process of moving rents on government-owned properties towards market or at least sustainability.

²⁸ In neither the Czech nor Slovak case was data collected on the income levels of borrowers.

²⁹ Duebel, Brzeski, Hamilton, "Rental Choice and Housing Policy Realignment in Transition: Post-privatization Challenges in the Europe and Central Asia Region," World Bank, 2005.

Annex 3. Selected Subsidy Types - Advantages and Disadvantages

Policy Goal	Subsidy Type	Advantages	Disadvantages or Challenges
Encourage property market development	Provide, publicize market data and studies Reduce transaction costs and shorten administrative processes	<ul style="list-style-type: none"> - Improve market efficiency, certainty - Create confidence on the part of buyers and sellers - Inexpensive 	
Encourage municipal and local government reforms	Link access to national subsidy budget to local reforms	<ul style="list-style-type: none"> - Provide a clear payoff to municipalities for transparent land allocation, efficient administrative processes 	<ul style="list-style-type: none"> - Verification and monitoring of reforms
Purchase of house or apartment, loan Affordability	Lump-sum cash grant towards down-payment or loan amount	<ul style="list-style-type: none"> - Transparent, simple to administer, easy to understand 	Requires land and /finance markets to work – responsive supply function
Reduce cost of rental housing	Investor tax credits	<ul style="list-style-type: none"> - Can make building of low cost housing feasible 	<ul style="list-style-type: none"> - Complex to administer - Not transparent - Requires responsive supply capacity
Reduce cost of rental housing	Cash rental vouchers to families	<ul style="list-style-type: none"> - Can make market rentals attainable for low income households 	<ul style="list-style-type: none"> - Complex to administer - Requires responsive supply of rental units

Policy Goal	Subsidy Type	Advantages	Disadvantages or Challenges
Loan Affordability	Concessionary interest rate	<ul style="list-style-type: none"> - Improves affordability - Easy to understand 	<ul style="list-style-type: none"> - An incentive to take on debt rather than to directly build or buy a home - Relatively opaque - If less than inflation, creates a wasting asset with a discounted market value - Reduces capital of the funding provider - Often lasts longer than the need of the borrower - Without proper targeting, worth more to wealthier buyers
Loan Affordability	Transparent interest subsidy for initial period of the loan, such as 5 out of 15 years (buy down of payment)	<ul style="list-style-type: none"> - Limits the subsidy to the time required for family to build savings, grow income 	<ul style="list-style-type: none"> - Efficiency is a function of the details of the design - Important to keep subsidy payment separate from loan structure to maintain marketable asset
Loan Affordability	Payment for mortgage default insurance	<ul style="list-style-type: none"> - Lowers loan-to-value ratio - Extends maturity of mortgage lending 	
Loan Affordability	Individual tax subsidies such as deductibility of mortgage interest and principle	<ul style="list-style-type: none"> - Politically attractive 	<ul style="list-style-type: none"> - Produces loans rather than homes - Often regressive – by definition worth more to high earners - Non-transparent cost in the form of tax expenditure