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Creation of the System of Contractual Savings for Housing in Belarus

Summary

Housing conditions in Belarus are similar to those in neighboring countries, but much worse than in developed countries. One of the key elements for successfully overcoming the problem of housing quantity and quality is a well-functioning system for financing housing. Creating such a system is of crucial importance for Belarus. One important component of a housing finance system is a contractual savings for housing (CSH) scheme. A law “On Contractual Savings for Housing” has recently been drafted. It defines all the major components of the future system, but contains several important drawbacks. Firstly, it limits competition between housing savings banks and does not allow private banks to operate in the CSH system. Secondly, it does not create incentives for banks to take part in the CSH system. Thirdly, it does not solve the problems related to volatile inflation. Fourthly, the government subsidy calculation mechanism is much too complicated for households. In this paper we propose ways of overcoming these drawbacks. Firstly, in order to create proper incentives for the banks and to promote competition between them, the banks should be allowed to make any type of contract approved by the supervision. Secondly, in order to reduce the risks associated with high and volatile inflation the draft law should envisage the possibility of linking the loan interest rates to the refinancing rate. If a bank chooses this kind of contract it could revise the loan interest rate once every year. Thirdly, the size, the maximum amount, and the schedule of state subsidy payments should be clearly defined in the legislation.

Contents

1. Introduction

Housing conditions in Belarus are typical for a post-soviet country in Europe. The total floor space per person was 21.9 m^2 in 2002, similar to neighboring countries. For instance, in Ukraine this indicator is 21.6 m^2 (in 2003), in Russia 20.0 m^2 (2002), and in Latvia 23.9 m^2 (2003). However, this is much lower than in developed European countries. For example, in Germany (former territory of the Federal Republic) the average person occupies more than 40 m^2 of floor space[1]. There are two major reasons for this discrepancy: the difference in household incomes and the limited access to financial resources and the high cost of housing loans in Belarus. The first item is related to general economic policy and to the historical heritage of the country and cannot be overcome in the medium term. The second problem could be solved through an appropriate policy aimed at creating a sound system of housing finance.

Currently, housing construction funds in Belarus derive mainly from bank loans, from central and local government resources, and from enterprises. Households finance less than 40%. Total housing loans amounted to about USD 200 to 250 m (1% of GDP) in 2004. About 3/4 of all housing loans for households are issued at preferential interest rates. The governments spend a rather large amount of their resources to compensate for bank losses caused by issuing loans at preferential rates: for the year 2004 the general government had planned to spend about USD 46 m, or 5.6% of all investment on dwelling construction. Nevertheless, the effectiveness of these outlays is doubtful: more than 500,000 families are now registered for improving their housing conditions, and their number decreases very slowly. Moreover, as housing loans are long-term loans, the banks should have long-term funds available to issue such loans. But more than 90% of all households deposits in the banking system are short-term, and institutions of long-term financing such as pension funds or life insurance are underdeveloped or do not exist in the country. Hence, creation of a system of long-term housing finance is of crucial importance to Belarus. One possible component of a long-term housing finance system is a system of contractual savings for housing[2]. This paper analyzes the possibility of introducing a CSH system in Belarus.

The paper is organized as follows. In the next section the general problem high and volatile inflation, being a major challenge for creating a CSH system in Belarus, is discussed. The third section briefly describes the main provisions of the draft law “On Contractual Savings for Housing”, which contain certain drawbacks and needs to be improved. In the fourth section the main drawbacks of the draft law are analyzed and proposals for overcoming them are made. The final section reiterates the main conclusions and provides a summary of recommendations.

2. High and volatile inflation as a key challenge for a Belarusian CSH system

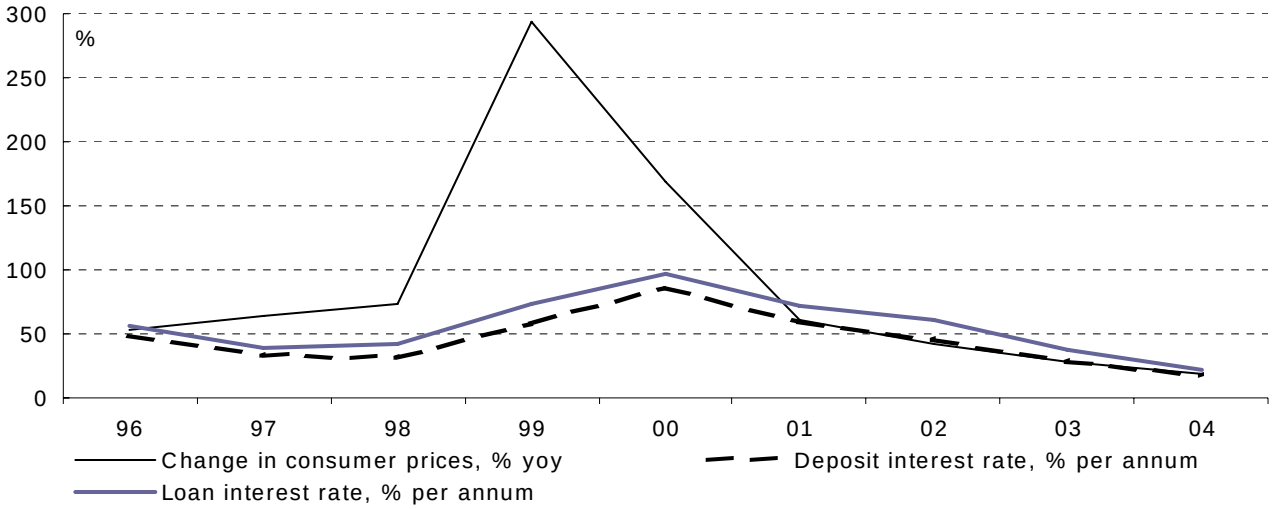
One of the basic features of contracts in a system of housing finance is their long-term nature. The main problem with any long-term contract is uncertainty. In a contractual savings case, typical (*Bauspar*-type) contracts provide certainty for households by fixing the interest rates (both for loans and deposits) in nominal terms at the beginning of the contract. However, for such a system to function stable and predictable inflation is one of the major preconditions.

Inflation and nominal interest rates in Belarus have been quite unstable over the recent past (Figure 1). Moreover, between 1997 and 2000 inflation exceeded the interest rate, i.e., the real interest rates were negative, which is destructive for any financial system. At present the situation is improved, but this may change again.

[1] Data sources: Ministry of Statistics and Analysis of Belarus, State Statistical Committee of Ukraine, Federal Statistical Office of Germany, Central Statistical Bureau of Latvia, Federal State Statistics Service of Russia.

[2] A comprehensive analysis of contractual savings schemes is presented in policy paper PP/13/04 “The Implementation of Contract Savings Schemes for Housing (Bausparen) in Belarus – Features, Recommendations and Examples”, see http://ipm.by/pdf/pp1304e.pdf.

Figure 1. Inflation and nominal interest rates



Note: Average interest rates for new loans and deposits.
Sources: NBB, Ministry of Statistics and Analysis.

In the case of Belarus, fixing the interest rates at the beginning of long-term contracts presents several risks for depositors and banks alike. In order to illustrate the problem, let's look at two scenarios:

a) Money deposited at the end of 1996 for a 4-year period (at a nominal interest rate of 34.8% per annum) would have been worth 89% less in real terms at the end of the contract term, since inflation for this period was 2896.7%. The value of a loan made for the same period would have decreased by 83% (the loan interest rate at the end of 1996 was 50.4%). This is known as the *risk of inflation acceleration*. It hurts the saver.

b) Money deposited at the end of 2000 for a 4-year period (at a nominal interest rate of 75.6% per annum) would have been worth 172% more in real terms at the end of the contract term. Similarly the value of a loan would have risen by 220% over the same period. This is the *risk of disinflation*, which is harmful to banks.

Thus, unstable and volatile inflation undermine the incentives of banks and depositors to invest money in long-term assets for the following reasons. Firstly, it can lead to substantial losses in wealth for both sides of the contract. Secondly, the uncertainty associated with unstable inflation creates liquidity management problems, for both households and financial institutions, and makes savings unattractive.

A CSH system is designed to operate in a low and stable inflationary environment. The obstacles caused by high and volatile inflation cannot be removed except by decreasing and stabilizing the inflationary environment. Until this is done, the potential of any CSH system is rather limited.

3. The draft law "On Contractual Savings for Housing"

In order to try to solve the problem of housing financing in Belarus, the Ministry of Architecture drew up a law, called "On contractual savings for housing". It has already been discussed within several interested ministries and organizations, such as the Ministry of Finance, the National Bank, etc. The Ministry of Architecture is now revising this draft law based on the input received from these organizations. We will now review the main features of the draft law[3].

[3] As contained in the version of August 2004.

3.1. Authorized financial institutions

The types of financial institutions that would be able to operate in the contractual savings for housing field are defined in the draft law. They are *universal banks* that have a license to receive household deposits and whose control stock is owned by the state. Currently, only 6 out of 32 banks meet these requirements, but only 4 of the 6 are serious candidates. Priorbank (which is one of the most active agents of the current housing finance system) and Belvneshekonombank have less than 50% state ownership. According to the draft law, the list of the banks allowed to operate in the CSH system is determined by the Council of Ministers and the NBB. The draft law also states that the number of banks simultaneously operating in the CSH system should be not less than three.

3.2. The type of system

There is no clear definition of the type of proposed CSH system in the draft law. The law envisages that not only deposits by households – participants of the CSH system – and funds obtained from principal and interest payments deriving from housing loans are sources for housing loans, but also *other funds and incomes of the bank*. Thus, the CSH system proposed in the draft law can be considered an open one[4].

3.3. Interest rate level

The deposit interest rate is intended to be set at the level of long-term deposits interest rate, and that at the moment of depositing the money. Usually interests for CSH system contracts are below the market rate in order to provide participants with relatively cheap loans. According to the draft law the loan interest is set at the refinancing rate level at the moment of issuing the loan.

3.4. Government subsidies

According to the draft law, the government will provide support for all households that participate in the system. The following formula is proposed in the draft law for its calculation:

Premium = inflation – deposit interest rate + 6 percentage points.

This means that the government subsidy (premium) should provide a real yield for deposits at 6% per annum. In the draft law inflation is defined as the regional price index for contractual work. As of the end of 2004, the premium would be equal to approximately 24.6% – 19% + 6% = 11.6% per annum[5].

In order to avoid an excessive burden on the state's expenditures, a maximum yearly deposit per household subject to subsidization is proposed. Its level is equal to 2600 rubles in 1991 prices. The "1991 prices" definition is used only in the construction.

3.5. Principles of supervision

Banks participating in the CSH system (housing savings banks) are supervised by the NBB according to the banking legislation, as they are universal banks and participation in the contractual savings schemes is one of their activities. A specific feature of the supervision is that it should insure that the deposits (according to the inflation definition in the draft law) are not decreased in real terms. Any penalty paid by a housing savings bank must be paid from its after-tax profit. It is not permitted to use resources obtained from its depositors for this purpose.

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[4] An open CSH system usually involves universal commercial banks that can use housing deposits to issue non-housing loans and non-housing deposits for housing loans. Interest rates on deposits in an open system are flexible. The most well known example of an open CSH system is the French *Epargne Logement* system.

[5] More precisely, the formula is: premium = (1.246/1.19)*1.06*100 = 11.0%.

4. Drawbacks of the draft law; and a CSH system appropriate for Belarus

The CSH law should create a general legislative framework only, issues of interest rate levels, supervision, government subsidies, etc. should be defined by regulations issued by the NBB, the Ministry of Finance, or other government bodies responsible for such issues. The Belarusian draft law is too detailed, which makes the legislative framework too rigid. Should some amendments to the CSH system become necessary in future, it would be much easier to amend the regulations of the NBB, etc., than to amend the law.

The draft law has a number of less "general" drawbacks[6], too. First of all, it reduces the competition within the CSH system by limiting the number of banks that can simultaneously operate within it and by the government stock ownership requirement. Secondly, an open system is less transparent and more difficult to monitor than a closed one. For the undeveloped Belarusian financial market, this puts an important burden on the system's development. Thirdly, one of the main problems of the analyzed version of the draft law is its method of interest rate setting. To predetermine the interest rate level at the refinancing rate limits the competition between banks, while the proposal to set the CSH deposits interest rates at long-term deposits interest levels undermines the incentives for banks to take part in the system, as these levels are higher than the refinancing rate. Finally, the proposed system is too complicated for households, as it uses a very complex algorithm for calculating the government premium. In the following sections we set forth our recommendations for eliminating the drawbacks of the current draft law.

4.1. Balance sheet segregation of CSH operations

The question of what type of financial institutions should be allowed to operate within the CSH system has two dimensions. The first (more general) is related to the type of these institutions – should they be like the German *Bausparkassen* (i.e. specialized ones) or universal. The second (concerning the Belarusian draft law) asks whether they should be state or privately owned, and whether their number should be limited.

The current legislation (the Banking Code of Belarus) does not allow the establishment of specialized financial institutions. Moreover, the NBB opposes the introduction of specialized financial institutions (for fear that they might lack liquidity in the long term). For this reason universal banks are the only available institutions for Belarus' CSH system. But since a CSH system operated by a universal bank lacks transparency, *the CSH operations of housing savings banks should be shown as segregated parts of their balance sheet.*

The limits on the number of financial institutions allowed to participate in the CSH system and the stipulation that these institutions be majority state-owned should both be eliminated. They restrict competition and leave no room for private banks to take part in the CHS system.

4.2. Open versus closed systems

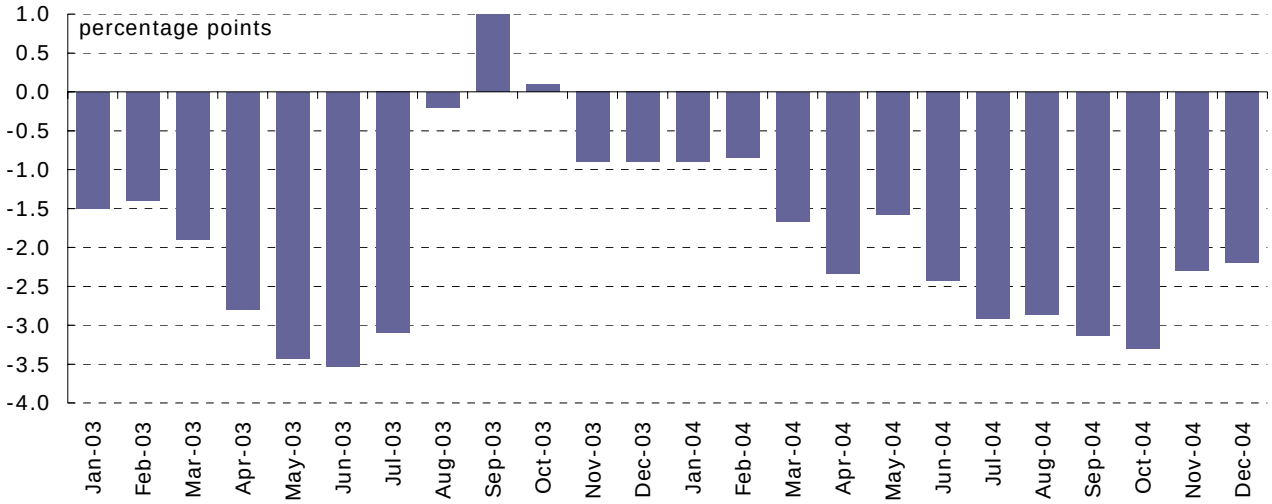
Sources for housing loans should only be resources earned within and allocated to CSH operations. The investment guidelines for CSH activities should be clearly defined by the law. A good example for this practice is the German Law on Housing Savings Banks. But as the Belarusian financial market is much less developed than the German one, the NBB together with the Ministry of Finance may want to establish special investment guidelines for the Belarusian housing savings banks.

[6] Since we are considering the August 2004 draft law version, the purpose of the paper is to contribute to the ongoing process of revising the draft law. The essentials of this paper and the draft law had already been raised during the round table discussion on "Problems and Perspectives of Contractual Savings for Housing System Creation in Belarus" held under the auspices of the Institute for Privatization and Management and the German Economic Team in Belarus on October 21, 2004.

4.3. Interest Rates: Liquidity management under volatile inflation

The consequences of the interest rate setting proposal in the draft law should be re-considered. In the recent past, the interest rate for deposits with maturities above 1 year, which can be seen as a proxy for the long-term deposit interest rate (the deposit interest rate in the CSH system according to the draft law) has been higher than the refinancing rate (the loan interest rate in the CSH system according to the draft law), as shown in Figure 2. If the interest spread of any market segment is negative, banks have no incentive to operate in this segment (ceteris paribus). The only thing that may create an "incentive" is a direct order from the authorities supported by compensation for bank losses. Evidently, such a solution cannot create a sound CHS system.

Figure 2. Spread between the interest rates for deposits with maturities above 1 year and the refinancing rate of the NBB



Source: NBB.

The principle of interest rate setting considered above has an additional negative consequence: it leaves no room for competition between banks in their interest policy. Besides, it provides no solution for the problem of volatile inflation. Evidently, these and other limitations that make participation in the CSH system unattractive for banks (or households) should be eliminated.

Hence, an appropriate solution should deal with the problem of volatile (over the long-term) inflation and allow banks to implement competitive interest policies. For these purposes we propose to envisage the *possibility* to link the nominal loan interest rate to the refinancing rate. The law *should not make this link mandatory, however*. The nominal interest rate could be revised once a year (e.g. at the end of the year) and then be fixed for the next year. This measure would somewhat reduce the uncertainty by creating clear expectations of the direction and scale of interest rate changes, as well as the other risks of high/volatile inflation. In addition, the banks should be allowed to make fixed interest rate contracts for the whole term of the contract. These measures would give banks incentives to participate in the CSH system and compete for the clients through interest rate policies. Additionally, households would get more certain contract conditions and lower the risks caused by volatile inflation. It provides them with higher incentives to participate in the CSH system, too.

However, the link to the refinancing rate is not the very best solution of the problem, because the uncertainty of long-term contracts can only be eliminated (especially in the case of Belarus) through fixed interest rates. Thus, the most general requirement for the appropriate and stable functioning of a CSH system in Belarus is to promote disinflation and macroeconomic stability.

4.4. Government subsidies and incentives for depositors

A well-designed CSH system should work without any external support, as the incentives for all participants could be distorted by external subsidies[7]. Yet, in countries with low confidence in the banking system, such as Belarus, the government may have to subsidize households (especially those with middle incomes) in order to attract them into the CSH system.

The method of calculating the government subsidy proposed in the draft law is rather complicated for households. The definition "1991 prices" is unclear for most households, because it is only used in the construction. An additional possible problem (for psychological reasons) is that many people associate the year 1991 with loosing their savings in Sberbank[8]. As a result, to define the state subsidy in this way can reduce its effectiveness as a tool to attract households into the system.

Another obstacle that should be abolished is the dependence of the size of the premium on inflation. We propose *to fix the size of the government premium at a predetermined level* (e.g. 25% of the yearly deposited amount[9]). Instead of imposing a limit on the size of the subsidized deposit it would be better to *limit the annual amount of the subsidy*. The maximum subsidy amount should be defined in Belarusian Rubles or another currency of deposit instead of "1991 rubles". In this case, no inflation definition would be needed in the draft law. Additionally, once the system starts to work efficiently, the government premium could be reduced or eliminated[10].

4.5. Selected principles of supervision

Since the Belarusian housing savings banks will be universal banks, they should be supervised by the NBB according to the banking legislation. The draft law envisages this. But we propose to add the following stipulations. Firstly, the supervision should approve the types of contracts allowed within the CSH system (with and without a link to the refinancing rate). Secondly, the requirement according to which "the supervision should reveal whether deposits in real terms[11] are not decreased" should be eliminated, as well as the inflation definition itself. The same supervision procedures as for other types of deposits must exist.

5. Conclusions and recommendations

1) The CSH law should create only a general legislative framework; issues of interest rates setting, supervision, and government subsidization should be contained in regulations issued by the NBB, the Ministry of Finance, or other governmental bodies responsible for these issues.

2) The CSH system in Belarus should be organized as a closed system offered through the universal banks with a segregated section in the bank's balance sheet for CSH operations.

3) Banks should have the possibility to enter into CSH contracts with fixed interest rates for the whole term of the contract. In addition, in order to reduce the risks of high/volatile inflation a linkage between the nominal loan interest rate and the refinancing rate should be envisaged. Supervision must approve the types of CSH contracts permitted.

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[7] But in the great majority of countries the state provides support to households that participate in CSH systems.

[8] All household savings in Sberbank (Savings Bank) of the USSR completely lost their value due to high inflation and due to peoples' inability to buy any goods for this money (very few goods – especially durables – being available at that time).

[9] The sizes of the premiums provided at the beginnings of the CSH systems in the Czech Republic, Hungary, Poland and Slovakia varied from 25 to 40% of the annual deposits, while a maximum subsidy size was imposed.

[10] This, however, is quite unlikely, because the experience of most countries with successful CSH systems shows that they retain their state supports despite the successes of their systems. Of course, any attempt to reduce this support meets with strong resistance from the households.

[11] According to the inflation definition in the draft law.

4) The sizes, maximum amounts, and schedules of the available state subsidies should be clearly defined in the legislation. All references to “1991 prices” should be eliminated; no inflation definition is needed in the law.

5) As housing savings banks in Belarus can be only universal banks, they should be supervised by the NBB according to the banking legislation without any specific provisions.

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