HOUSING FINANCE IN ARMENIA

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The paper outlines how housing finance has developed and examines what challenges must be met to assure continued development. Armenia's primary market has benefited from extensive reforms and from wide-ranging analysis by domestic and international experts. The paper emphasizes the need for continued legal reforms, improved maintenance of residential real estate, increased use of brokers, improved construction and mortgage finance, and capital market development to enable long-term mortgage financing.

I. THE GOVERNMENT IS PROMOTING MORTGAGE FINANCE

Armenia's primary market has benefited from extensive reforms and from wide-ranging analysis by domestic and international experts. The Central Bank of Armenia (CBA) and Ministry of Finance and Economy (MFE) each have written concept notes on the development of the market. The government has formed a working group to coordinate legal and other reforms. Headed by the Cadastre, the working group also includes the CBA, MFE, and the Ministry of Justice (MOJ).

II. CURRENT LEGAL REFORM EFFORTS ARE IMPORTANT

Following the extensive analytical work completed on needed legal reforms, the MOJ has proposed an important package of reforms that is currently being discussed by policy makers in the executive and in the parliament. The package includes measures to: define real estate as a combination of land and buildings; clarify, simplify, and shorten the mortgage foreclosure process; reduce or eliminate the rights accrued to residence by minor children and other relatives; and define a partially constructed building as an asset appropriate to serve as collateral. In addition, the government could consider legal measures to clarify the treatment of collateral covered bonds in case of failure of the issuer, and to define the bankruptcy remoteness of special purpose vehicles for securitization.

III. THE REAL PROPERTY MARKET HAS BENEFITED FROM IMPORTANT REFORMS

Armenia has established two major elements of a property market: it has privatized much of the housing stock and it has reformed its property registration system. Almost all housing units (97 percent) have been privatized by their occupants. The state has ceded state-owned urban land to municipalities. Rural land has been privatized partly, with reserves and a large balance of non-arable land remaining in the hands of the state. Much of the housing stock is poorly maintained, however, property sales are predominately arranged by word of mouth, and most house price growth is restricted to Yerevan.

Much of the urban land in and around Yerevan has been privatized. Municipalities sell off urban land is sold in tender offers. Purchasers then sub-divide and re-sell parcels. Market participants cite large discrepancies in a short time period between the land price at tender and the subsequent sale of smaller parcels, raising questions about the transparency and efficiency of the public tender process.

IV. DEFERRED MAINTENANCE REDUCES THE VALUE OF PRIVATIZED APARTMENTS

As in other transition economies, much of the stock of residential real estate has not been well maintained over the past 15 years and so is in poor condition. Lack of maintenance resulted in part from a shortage of resources that resulted from the economic crisis that accompanied the rapid transition. But more importantly, most people fail to accept the responsibility for maintaining the buildings in which they own apartments. A lack of maintenance reduces the value of properties and their value as collateral for mortgage finance.

In economies with well-developed housing markets, apartment owners share in the cost of maintaining their common spaces through condominium associations.[17] A condominium association is a legal body made up of the apartment owners of a given building. Each owner is a member, and the members elect a governing board. Members vote on an annual budget for routine repairs, cleaning, and maintenance of the common spaces and structure. The condominium association collects a monthly maintenance fee from each homeowner and contracts for required work. For unusually large projects, such as replacing the roof, the condominium association will undertake a special levy from the homeowners.

In Armenia, as in most transition countries, municipalities have been responsible for maintenance and provision of housing services; however, once apartments are privatized, the responsibility for maintenance falls on the new owners. In any case, municipalities no longer have the resources to maintain the entire housing stock. The legal support for condominium arrangements exists in Armenia, but few condominium associations have been formed. Buildings with economically heterogeneous households have difficulty setting adequate fees. In practice, municipalities remain responsible for maintenance but have resources only to make emergency repairs. As a result, routine maintenance is not provided, and the housing stock continues to deteriorate.

V. REAL ESTATE MARKETS ARE GROWING, BUT MOSTLY IN YEREVAN

Overall transaction volume of residential real estate has almost doubled in the past four years, from about 12,500 apartments and houses sold in the year 2000 to about 24,000 in

[17] In addition to the condominium structure, many countries use cooperative structures to organize the ownership and maintenance of common spaces.

the year 2004. About 75 percent of transactions took place in Yerevan and its surrounding provinces.[18]

Reported prices for both land and dwellings in the country as a whole rose an average of 13 percent per year from 1999 to 2004. Prices have risen particularly rapidly in recent years. In 2004, prices rose 32 percent in the country as a whole and 29 percent in Yerevan. Reported prices are believed to be understated to reduce tax liability, and so official figures probably do not reflect actual land price growth. For example, industry participants state that desirable urban lots in Yerevan that sold for US$40 per square meter in early 2004 now would sell for US$200 per square meter.

Demand for real estate is centered predominately in the capital, in particular in the city center. Property in Yerevan sells at a substantial premium over other cities, and the price growth of housing has been more rapid in Yerevan. The price per square meter for an apartment in Yerevan averaged US$230 in 2004, versus US$74 in Gyumri and US$63 in Vanadzor. Where the apartment price per square meter grew 32 percent in Yerevan between 2003 and 2004, it grew only 7 percent in Gyumri and 4 percent in Vanadzor. Within Yerevan, the price per square meter ranges between US$462 for apartments in the center, and US$80 per square meter in the cheapest district.

VI. Registration and Transfer Have Improved

Efficient title registry and transfer is essential to the functioning of real estate markets. Registry and transfer of title to real property have improved dramatically in recent years. According to the government, almost all of the country's 2.5 million privately-owned land parcels and buildings have been surveyed. The unified title registration system is based on and supported by appropriate legislation and implementation regulations. Information is provided to clients within a day, and registration of real estate transactions takes one day for most cases and up to three days for more complicated ones.

VII. Increased Use of Professional Brokers and Appraisers Could Contribute to Transparency and Efficiency

Professional brokers and appraisers can add transparency to markets by providing third-party information about prices and values. In Armenia, real estate brokers are involved in only about 10 percent of real property transactions. Brokers charge a fee of five percent, which may be paid either by the buyer or seller, according to negotiation. The appraisal fee is set by the government at the equivalent of US$30 for a residential property. Some lenders require the buyer to pay the appraisal fee, but some include the fee in the interest rate paid for the loan. Brokers and property appraisers are each licensed by the State Committee on

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[18] According to the United Nations, in 1998 Yerevan accounted for 1.24 million people, just under a third of the country's population. The second and third largest cities are Gyumri, with a population of 212,000 in 1998 and Vanadzor with 173,000. Since 1998, many Armenians have continued to emigrate as they are able to find work in other countries. In addition, the collapse of Soviet-era industry in the regions has resulted in the bulk of economic activity centering on Yerevan. As a result, since 1998, most observers believe that Yerevan has grown, while Gyumri and Vanadzor have shrunk.

Cadastre through examinations that industry participants consider comprehensive and thorough.

The National Association of Realtors and Appraisers (NARA) has undertaken a number of important initiatives to professionalize the industry. These include the development of a multiple-listing service (MLS) and consumer education programs on mortgage borrowing and real estate investment. As it develops a database of property prices through its nascent MLS, and is able to access data from the Cadastre, NARA plans to publish industry data on prices and transactions. With time, these initiatives should help to reduce the transactions costs of buying and selling property and introduce transparency into real estate pricing and lending.

VIII. Construction Finance is Limited and Risky

Risky construction finance raises the cost of new construction and reduces the supply. Residential construction made up about 47 percent of the total value of construction in 2003. Construction is growing in and around Yerevan, but not much in the rest of the country. The dwellings delivered are expensive, averaging US$53,000 versus an average annual public sector wage of US$678.[19] Newly built apartments will not be accessible to low-income families so long as the construction process remains risky and expensive.

In countries with efficient housing-finance markets, banks finance construction and manage the associated project risks. In many countries, including some emerging markets, such as Mexico, construction loans are securitized. In Armenia, there is no bank lending for residential construction. Developers pay for land with their own equity and that of investors. Construction is financed with deposits from apartment buyers. Buyers will pay for at least half the cost of a unit in monthly payments over the period of construction.

One reason for the lack of bank lending in Armenia is that, currently, a building cannot be classified as an asset until it is 80 percent complete, making construction projects useless for the purpose of loan collateral. The MOJ is developing reforms that would remedy this and other legal shortcomings with respect to real property.

The financing of construction with deposits transfers project risk and financing risk from the developer to the buyers. Few buyers are equipped to manage such risk. In a recently televised scandal, a developer and constructor sold some of the same units in a building under construction to multiple families. Given the widely-acknowledged inefficiencies of the courts and the cost of going to court, the developer and constructor are likely to have the advantage in any resulting court case. Besides questions of risk, financing construction with buyer deposits is ineffective in reaching the broad population. Most households will not have the means to pay half the US$18,360 cost of an average Yerevan apartment.

The CBA and the Union of Banks could collaborate to develop construction lending-products and develop expertise in project management. Even if it is a new market for them,

[19] Official household income figures in Armenia exclude remittances and the informal incomes. Remittances and informal sources may raise the average income to as much as US$2,000 annually, a level that is still inadequate to support the average cost of a new apartment.

over the long run banks will be better equipped to manage project risk than are individual apartment buyers.

IX. The Primary Mortgage Market is Small but Promising

Six of the 18 active Armenian banks have begun to originate mortgage loans, primarily to upper income individuals, but increasingly to moderate-income households for renovation. Renovation and "trade-up" loans for relatively small amounts should be a large market for banks, given the almost universal privatization of the housing stock and the history of poor maintenance. Some market studies have put the demand for such loans at 40,000-50,000 households with resources to repay them. As the government succeeds in strengthening the legal framework, banks should be encouraged to lend at more favorable terms.

To reach more moderate and lower income families, it will be important for Armenian banks to lend for longer terms and higher loan-to-value ratios (LTVs). The current system-wide mortgage portfolio is small by international standards, about two percent of GDP.[20] At the end of January, 2005, banks held 4,918 mortgages to individuals worth a total of US$42.3 million, for an average of US$8,609 outstanding balance per loan. LTVs at origin were 44.3 percent, and the weighted average rate of interest was 20.4 percent. New originations continue to be in U.S. dollars, at fixed interest rates ranging between fourteen and eighteen percent, for low LTVs of 50 percent, at a short average term to maturity of five years, to a maximum of seven years. In contrast, banks in emerging markets with less favorable frameworks for creditors' rights lend for terms of ten and fifteen years, with loan to value ratios of 70 percent.[21] Highly developed markets lend as long as 30 years for loan to value ratios of 80 and 90 percent.

Importantly, macro conditions are currently positive. Inflation has remained low for the past eight years, and interest rates have fallen dramatically since the current portfolio was originated. At least two lenders expect to reduce rates to their best customers to twelve percent in the near future.

X. Standardization Would Help the Mortgage Market to Grow

In efficient mortgage markets, lenders produce standard loans that can be traded like commodities. As a result, they are liquid and valuable assets for the lenders and for institutional investors. Portfolios of such loans can be traded to raise cash or better allocate capital. They serve as collateral for securities that, in turn, can be used as collateral for repurchase agreements between commercial banks and central banks. Their liquidity and value permits them to serve as agents for allocating risk within the financial system, in the form of collateral for mortgage bonds and mortgage-backed securities.

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[20] Among transition countries, Poland, Hungary, and the Czech Republic all have larger portfolios in terms of GDP. Highly developed markets in Western Europe and the Americas reach 50 and 70 percent of GDP. The Russian mortgage market is less than one percent of GDP.

[21] Mortgage foreclosure is expected to take between six months and a year in Armenia. In Colombia, mortgages have long been for between 15 and 20 years, even though the estimated time to foreclose on and sell collateral has averaged reduced up to five years.

As an example of practices that will obstruct the development of long-term funding, several lenders offer “fixed” interest rates that can be changed at the discretion of the lender. Such administrated rates will not prove suitable as collateral for mortgage bonds or securities, as investors would not be able to estimate cash flows. Loan rates need either to be fixed completely, or, if they are adjustable, they must adjust mechanically in relation to a publicly available index, such as the average rate on thirty-day government bills.

To develop a liquid lending market and set the stage for funding mechanisms such as covered bonds or securitization, banks need to originate loans to common and well-understood standards for contract terms and underwriting requirements. The CBR has drafted standards for the use of lenders that are in turn based on European Bank for Reconstruction and Development (EBRD) standards. It would be useful for the CBA and the Union of Bankers to develop training programs for bankers in risk management and mortgage underwriting.

Specific recommendations for the primary market include:

- **Encourage new methods to manage credit risk.** Banks are adopting measures to better manage credit risk, particularly for borrowers with limited documentation of income sources. In facing the current situation of the large informal economy, lenders are using techniques such as savings patterns, expenditure patterns, and limited credit histories to establish creditworthiness. Such means should be encouraged and the resulting performance data should be made available to the public and private credit registries.

- **Analyze thoroughly the costs and benefits of any proposed subsidy scheme.** Any subsidy to buyers should satisfy the criteria for equity (all potential recipients receive similar subsidies or if they vary they vary by need), efficiency (they go to the intended recipients with minimal overhead cost), and minimal market distortion. Savings and interest rate subsidies have been suggested in at least one of the currently debated proposals. Among the potential ways to encourage the development of the market, savings and interest rate subsidies could be considered among the least equitable and least efficient. In several countries, savings subsidies have served to capture the savings of the relatively wealthy, without producing any new housing units. Interest rate subsidies have proved particularly distortionary in several Latin American housing markets.

- **Develop adjustable rate mortgages in drams.** Since interest rates fall as a result of increased confidence and on-going macroeconomic stability, bankers could consider offering floating rate loans in drams. Adjustable rate mortgages could prove more affordable to moderate income borrowers and could promote de-dollarization of the economy. The CBA and Union of Bankers could collaborate to develop product designs with rate adjustments mechanisms that make sense given the government bond market. The CBA could develop its bond issuance to provide consistent liquidity at one or more points on the yield curve that would make the index dependable and eventually lead to the development of forward contracts that would in turn enable pricing of hedges on the adjustment features of mortgages.

- **The CBA should continue to support the development of private credit bureaus with functionality beyond that of the credit registry and continue to encourage banks to participate in the development of the credit database.** Since private credit bureaus are able to develop reliable information and eventually develop credit scores, CBA provisioning and capital standards could be adjusted to recognize higher quality credits as supported by data. At the same time, the government should balance development of such databases with adequate protection of consumer privacy and safeguards against identity theft.

- **Improved disclosure of mortgage lending, pricing, performance.** Broadly available and accurate information boosts confidence in markets. The quick release of extensive public information is a critical success factor for any efficient mortgage market, whether it is that of Denmark, Germany, Ireland, or the United States. Armenian banks should disclose on a monthly basis detailed data about the mortgages they have originated and about the performance of outstanding mortgages. Data should be organized by annual cohort and include elements such as: currency volume, number of loans, currency weighted average rate of interest, the mechanics of any adjustment feature; regional location, weighted average loan to value ratio, prepayment rates, default rates, and cure rates.

- **Regular analysis of housing and mortgage demand and supply.** A common function of governments is to furnish data that contributes to market transparency and efficiency. The Armenian government could establish a periodic survey that estimates demand and supply for housing on a regional and national basis.

- **Improve collection and publication of real property information.** The Cadastre and NARA could collaborate to produce property price data that reflects the quality of properties traded. The CBA could collaborate and sponsor part of the cost as a means to improve the quality of asset valuation. The Cadastre has made an important start with its information on title registrations and transfers. The NARA is developing a multiple listing service and could develop a database of appraisal values. These sources could be combined to use proven methodology to track real estate values, such as price indices and repeat sale-price indices. Particular attention should be paid to the value of improved maintenance, as a way to document the value of forming effective condominium associations and maintaining buildings well.

- **Improved consumer disclosures.** Helping consumers to understand mortgages will help to boost confidence in the product and in the industry. Mortgages are complex and intimidating to most consumers. They represent funding for the single largest purchase the consumer is ever likely to make. The government could promulgate norms for banks on the disclosure of mortgage terms to consumers. The Mexican government has recently developed a model law that requires banks to post the rates and terms of mortgage products on an easily visible poster in every bank branch.

XI. INADEQUATE CAPITAL MARKETS LIMIT LONG-TERM FUNDING FOR MORTGAGE LENDERS

Capital market funding through mortgage bonds or securitization could help develop cheaper mortgage finance for individuals and contribute to the strength of the financial sector. Currently, the only bond issuer in Armenia is the government, and its supply is limited, leading to limited liquidity. Rating agencies are not active. Domestic corporations do not issue, and international corporations rely on their parents for funding. Aside from banks, there is currently no institutional demand for long-term investments. The state social insurance fund maintains no surplus to invest, and insurance companies lack any meaningful capital surplus, relying on offshore reinsurers to cover the bulk of their risks; however, retail investors are interested in alternatives to cash and real estate for their long-term savings.

Mortgage lenders currently fund their businesses with short-term deposits. As long as portfolios are small, term mismatch will not present a serious risk to lenders. Several lenders plan to make mortgages only 10 percent of their total lending portfolio. There is not yet widespread discussion of market risk measures (such as duration of equity, or use of an options approach to prepayment risk, although prepayment rates appear to be large).
During the time that it takes to create institutions that would invest in mortgage bonds or securities, the government and authorities could encourage the development of alternative sources of long-term funds for banks, and in the medium term, of an inter-bank mortgage bond market. Short-term measures include:

- **Create a liquidity facility.** The government and authorities have been debating the creation of a liquidity facility that would provide long-term funding to banks. Given the weaknesses and inexperience of commercial banks in mortgage portfolio and bond administration, the current proposal from KfW Bankengruppe to set up and fund a private sector facility that would buy mortgages from banks and eventually issue bonds has merit. The facility as proposed would be in the private sector, and would work together with the CBA and the Union of Banks to promote underwriting standards and training for banks. The key issues for such a facility are: 1) that it leave credit risk in the hands of the originating banks, so all loan purchases are on the basis of full recourse to the selling institution in the case of default; 2) that it be run on a commercial basis, pricing its purchases to earn a market hurdle rate of return; and 3) that it be regulated by the CBA with the same rigor that is applied to commercial lenders.

- **Pass a mortgage bond law and a mortgage securitization law.** Until the terms of such instruments are defined, their legal status will be unclear. The government could develop laws that provide clear legal status for these instruments and that guide the CBA and Securities Commission in their regulation. A mortgage bond law should cover issues such as: the isolation of the bond collateral in case of bankruptcy of the issuer, acceptable collateral for the bond, and the term matching requirement of collateral and bond. A securitization law would cover the establishment of special purpose vehicles that are remote from the issuer in case of issuer bankruptcy, the allowable actions of such special purpose vehicles and their status as legal entities, the creation of senior and/or subordinate structures, and the exemption from Value-Added Tax (VAT) of portfolio sales to special purpose vehicles.