III. *FINANCIAL FRAMEWORK*

Lithuania's housing sector is well into the process of transition: the housing stock is largely privatized, some new types of housing organizations and intermediaries have developed, and there are certain arrangements for trading and mortgaging residential property. However, new housing construction is in the doldrums and arrangements for housing capital reinvestment and maintenance (not least those needed to improve the stock's energy efficiency) are patchy.

This chapter covers housing investment and financing of housing provision. A special emphasis is placed on the development of mortgage infrastructure and mortgage products that enable the operation of the housing market. In addition, it explores changes in housing demand, focusing on housing costs, affordability, housing subsidies and allowances.

A. Housing investment and financing of new housing construction

Housing investment

In 1993-1998, the absolute level of investment in housing almost doubled (in current prices), as private individuals became the main contributors to the investment process, particularly following privatization and the elimination of restrictions on private construction. However, housing investment decreased within the portfolio of total investment from some 23 per cent to 7.4 per cent in the 1993-1998 period, as in most countries in transition, due to the collapse of public investment in housing (see **table 17**).

Table 17. Housing investment, 1993-1998

Type of investment *(in current million litai)*	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
Capital investment	1160	2311	3163	4380	5488	6834
Total investment in housing or residential buildings	**266.2**	**465.3**	**503.0**	**570.3**	**560.5**	**507.5**
- share of total capital investment	*22.9%*	*20.1%*	*15.9%*	*13.0%*	*10.2%*	*7.4%*
1. Public sector investment in residential buildings	**79.1**	**74.0**	**44.8**	**36.9**	**44.6**	**86.6**
- share of total investment in housing	*29.7%*	*15.9%*	*8.9%*	*6.5%*	*8.0%*	*17.1%*
2. Private investment	**187.1**	**391.3**	**458.2**	**533.4**	**515.9**	**420.9**
Occupiers' assets	**175.5**	**361.1**	**429.0**	**511.1**	**505.9**	**394.4**
- share of total investment in housing	*65.9%*	*77.6%*	*85.3%*	*89.6%*	*90.2%*	*77.7%*
Other sources of private investment in housing	**11.6**	**30.2**	**29.2**	**22.3**	**10**	**26.5**
- share of total investment in housing	*4.4%*	*6.5%*	*5.8%*	*3.9%*	*1.8%*	*5.2%*

Sources: Statistical Yearbook 1999 (Vilnius, 1999);
Data supplied by the Institute of Architecture and Construction, Kaunas, May 1999.

Private individuals' investment in housing almost tripled in the period 1993-1997. Yet, recent data reveal that there are warning signs that should be addressed. First, the absolute amount of private and other investment started to decrease in 1997. Second, private individuals made 90 per cent of total housing investment in 1997, which indicates that housing is not considered attractive by institutional investors. During the reforms, conditions have not been secure enough to attract potential institutional investors. The housing market remains in the hands of owner-occupiers, which makes it difficult to raise the capital needed to increase housing production, especially when *average household income is still very low* (see **below**). The data confirm that the *significant increase in individual housing investment has been unable to compensate for the shortage of other sources.* Consequently, housing's share in total investment has nearly halved.

In the period 1990-1994, new housing construction decreased by 70 per cent (**chapter II, table 14**). Such falls have been common to all countries in transition (50 per cent on average), but in Lithuania the change was much more dramatic. Construction output grew by 6.6 per cent in 1997 (**chapter I**), mostly due to State investment, but its share of GDP remains relatively low, as shown in **table 3** (**chapter I**). Forecasts by the Institute of Economics and Privatization show construction increasing to 7.8 - 8.2 per cent of GDP by 2002. The housing sector is not viewed as a major economic force in the Lithuanian economy.

Financing land development and housing construction

Although not in physical short supply, the housing land market is developed. Land transactions after privatization doubled in 1997, but the sales of land parcels only account for 1.34 per cent of the total number of transactions (building sales represent 14 per cent). [1] Complexities arise from local, county and State involvement in the disposal of public land. The process of land acquisition by legal entities is not clear and transparent, although the tender procedure is used for these purposes. There are further complexities in developing leased land. Nevertheless, the active privatization of the housing stock and State-run industries means that attention is now focused on State-owned land. The State is about to privatize much of its land holdings and this offers a number of opportunities.

There is also very limited financing available for housing land acquisition and development. There is no banking lending system for the process, although land, with all future modifications, can be pledged. The major reason is that banks do not consider undeveloped land as being sufficiently liquid collateral. On the other hand, there are few commercial enterprises that specialize in financing land development and the demand for such loans is very limited.

At the moment municipalities are responsible for infrastructure development, but budget restrictions impose severe constraints. Local governments are heavily dependent on central government transfers with very limited opportunity to generate revenues of their own. Overall, the lack of adequate land development financing leads to a significant shortage of land parcels with developed infrastructure available for sale. In 1998, the Ministry of Finance proposed the Lithuanian Municipal Development Programme to assist in the development of a system of municipal investments in infrastructure and municipal services and so support the reform of local government finance. The programme seeks to provide training, technical assistance and investment support to about 40 of the 56 municipalities by the year 2002 using lines of credit provided by foreign and international financial institutions. Subprojects funded through the Municipal Development Programme will focus on infrastructure loans that can be repaid through user fees. In most cases the municipal enterprise will be the final borrower, and the municipality will guarantee the loan (in accordance with the Law on Municipal Borrowing).

The Law on Municipal Borrowing specifies the following conditions:

- Outstanding debt principal cannot exceed 20 per cent of annual revenues. In exceptional cases the Ministry of Finance may allow an increase up to 50 per cent;
- The annual borrowing limit of a municipality is 10 per cent of annual revenues, including a 5 per cent limit on short–term borrowing;
- The annual debt service related to borrowing cannot exceed 10 per cent of annual revenues;
- The municipality or its enterprise should contribute at least 10 per cent of the total cost of the investment and project preparation costs.

Shortages of affordable and accessible housing construction finance are manifested in recent trends in the sales of new housing, escalating construction prices, a reduced volume of housing production, as well as an increasing number of uncompleted dwellings. *Existing arrangements for new construction finance are still far from efficient and new construction finance continues to be a problem.* Significant changes have taken place in the financing of residential construction during the period of transition. The Government's policy focused on defining its new role from a major developer and supplier of new housing to enabler, providing State support for new construction financed through personal savings. Housing finance reforms centred mainly on:

- Re-allocating responsibilities from the State in housing construction finance;
- Establishing extrabudgetary State and self-government support funds for construction;
- Reducing significantly the direct finance of construction through both the State and municipal budgets.

The reduction in direct State financing was supplemented with a governmental programme for subsidized construction financing ('Bustas'). Housing construction associations (cooperatives) and individuals on the waiting lists could apply for a 5 per cent interest rate construction loan over 25 years, interest-free for 3 years and with a 80-90 per cent loan-to-value ratio. The subsidies are paid from the General Support Fund raised

[1] Data provided by the State Cadastre and Register, Vilnius, May 1999.

from revenues from housing privatization, land sales and the State budget. Municipalities also created their construction funds, which get 10 per cent from the State fund resources. This programme is expensive to the Government and in 1996 amounted to approximately 3.4 per cent of the central Government budget. [2]

The availability of cheap financing from State funds and tax privileges made the provision of new housing through construction associations (cooperatives) particularly attractive until 1995. Most of the funding designated for low-interest loans was assigned to these organizations. During 1993-1995, they received 129 billion litai in low-interest credit. After that, existing cooperatives were re-registered as housing construction associations to complete the construction process. Subsidized construction finance is no longer available to housing construction associations and supports only the completion of housing.

Lithuania's current system for construction finance has the following basic characteristics:

- Informal financing of construction by private individuals is the predominant form. It relies on small, personal savings, sometimes organized into mutual forms of finance, such as construction associations. This leads to an unprofessional approach to financing where owners become 'self-developers' with little opportunity to effectively manage the risks associated with the development process;
- Development companies sometimes organize future buyers into associations, supplying them with building and developer services, which allows some tax advantages and easier access to public funding;
- Limited direct State financing of the construction of public housing and for target groups, with plans that municipal financing should make up not less than 15-20 per cent of construction investment;
- Low levels of commercial construction finance available to those able to manage effectively development and construction risks, to improve construction technology, and develop the construction industry through competition.

The last point is illustrated by information presented in **table 18**. The value of total housing loans to the value of all outstanding loans in both commercial and government financial institutions in the fourth quarter of 1995 was 12.5 per cent. In September 1999 it decreased to a mere 3.5 per cent. A network of temporary subsidiary companies also undertakes some of this activity.

Table 18. Loans for construction [a/]
(In thousands of litai)

	Loans for construction	All loans	Share
I quarter, 1995	328,847	3,639,296	9.0%
II quarter, 1995	351,192	3,643,122	9.6%
III quarter 1995	380,761	3,676,331	10.4%
IV quarter, 1995	387,072	3,107,937	12.5%
I quarter, 1996	390,400	2,875,211	13.6%
II quarter, 1996	393,721	2,828,685	13.9%
III quarter 1996	402,174	3,005,328	13.4%
IV quarter, 1996	334,769	3,041,866	11.0%
I quarter, 1997	131,286	2,844,587	4.6%
II quarter, 1997	115,751	2,656,901	4.4%
III quarter 1997	116,313	2,831,685	4.1%
IV quarter, 1997	128,474	3,231,757	4.0%
I quarter, 1998	100,112	3,338,776	3.0%
II quarter, 1998	129,447	3,455,029	3.7%
III quarter 1998	140,533	3,671,283	3.8%
IV quarter, 1998	140,387	3,993,875	3.5%
I quarter, 1999	149,344	4,577,258	3.3%
II quarter, 1999	188,913	4,968,634	3.8%
III quarter 1999	180,880	5,097,243	3.5%

Source: Bank of Lithuania: Statistics – Loans by Economic Activities, http://www.lbank.lt
[a/] Data refer to end of period.

[2] Staff Appraisal Report Republic of Lithuania Energy Efficiency/Housing Pilot Project, The World Bank, 1996.

In summary, *Lithuania at the moment has a limited capitalized and institutionally backed development sector with little support for entry-level firms.* Housing development remains fragmented.

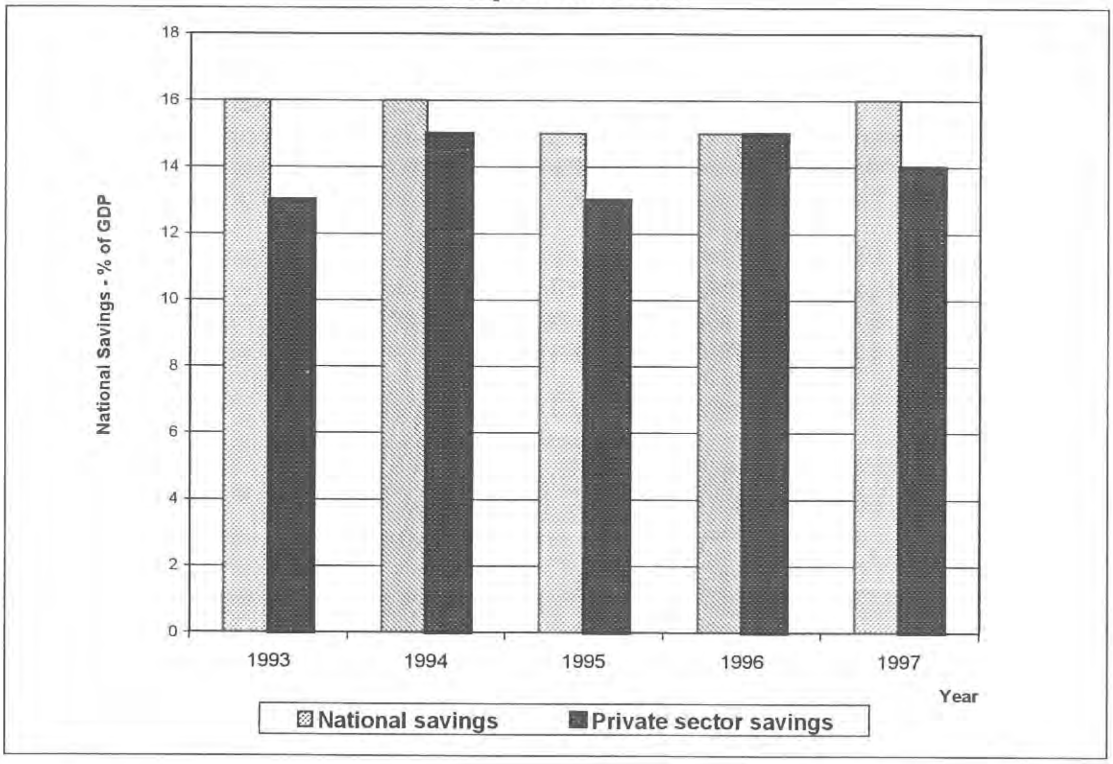
B. Factors affecting demand for housing

Savings

Like other countries in transition, Lithuania started its economic reforms without sufficient local financial resources and savings. At the end of 1997, bank deposits equalled 5.9 billion litai, of which private account deposits stood at 2.2 billion litai. Foreign currency deposits equalled 2.3 billion litai and stood at 39 per cent of local and foreign currency deposits. The banking sector has not accrued sufficient savings, especially for long-term lending. With a predominance of short-term deposits, bank deposits comprise only 15.4 per cent of GDP. In more successful economies in transition they stand at 30 per cent.[3]

During the transition the Government has failed to develop efficient tools to prompt growth in national and private sector savings, which remain low (see **fig. VIII**).

Figure VIII: National savings
(In per cent of GDP)



Source: United Nations Development Programme, Lithuanian Human Development Report 1998, (Vilnius, 1998).

The situation with respect to household savings is similar, though it might be considered better in terms of total savings and investments' share of household income according to data[4] in **table 19**. Policies need to be developed to attract private savings and investments into the housing sector. Specifically, there are no financial

[3] United Nations Development Programme, Lithuanian Human Development Report 1998 (Vilnius, 1998).

[4] The data provided in the table 19 are not official and are used for illustration only. To collect data, the Institute uses expert opinions instead of a household budget survey. It should be interpreted with care. The author preferred the data for two reasons. Firstly, the shadow economy exists, only part of the population declares its income and consumption expenditure exceeded the disposable income per capita in 1997-1998. Secondly, the official statistics do not yet show income from savings and investments.

instruments, such as housing, municipal or private developer government-guaranteed bonds, notes or other housing-related securities, which could become an attractive savings instrument for channelling funds into housing construction or purchase. Investment funds designed for equity investment do not appear to operate due to the lack of an adequate legal base and unfavourable tax treatment. Furthermore, credit unions (or savings and loan financial institutions) do not yet play a significant role in the financial market.

Table 19. Monthly household income, 1st half of 1998
(In litai)

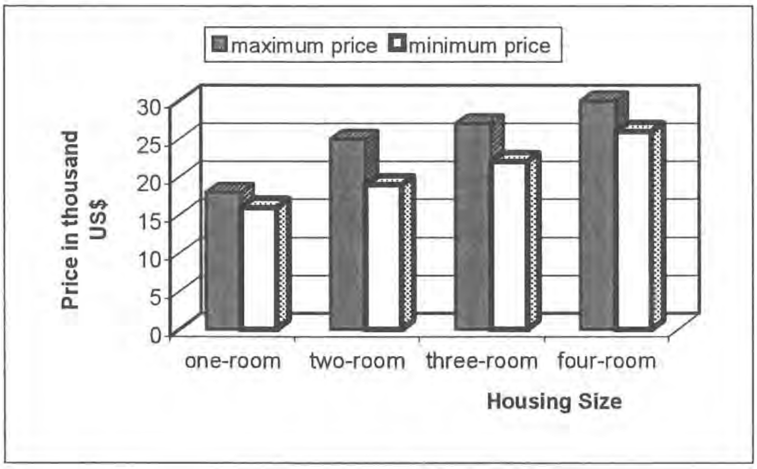
Indicator	City		Town		Rural	
Household income	2,186	100%	1,635	100%	996	100%
Household savings	313	14.3%	204	12.5%	110	11.1%
Household investments	264	12.1%	164	10.0%	80	8.0%
Household savings and investments	577	26.4%	368	22.5%	190	19.1%

Source: Lithuanian Free Market Institute, A Survey of Macroeconomic Variables in Lithuania 1998/99 (Vilnius, 1999).

Incomes and affordability

Following a dramatic fall at the start of the transition, personal income experienced some positive growth and adjustment. Monthly disposable income started to increase and in 1997 equalled 368.92 litai per household member. In general, household income has also increased, however salaries vary significantly and roughly 8 per cent of the employees in 1997 had a monthly salary above 1,500 litai. [5] Income inequalities remain relatively high. The Gini index, which reflects the extent to which the distribution of income among individuals within an economy deviates from perfectly equal distribution, was 0.31 for Lithuania in 1997. In eastern European and the Baltic countries the index fluctuates between 0.25 and 0.34. [6] Consumption inequality in Lithuania is increasing also. According to the 1998 Lithuanian Human Development Report, as many as 37.2 per cent of households with three children or more are poor; and more than a quarter of the rural population is impoverished. The incidence of poverty among those with primary and secondary education is six to seven times higher than among those with a tertiary education.

Figure IX: Prices of standard flats in Vilnius, 1998



Source: Data supplied by the State Land Cadastre and Register, May 1999.

Despite positive trends in income growth, house purchase remains unaffordable for a large number of Lithuanian households. Calculations based on household income and savings data in **table 19**, as well as house price data, show that it will take 10 to 14 years of saving to become a flat owner in Vilnius. The estimate reflects

[5] According to the Housing Credit Foundation, Vilnius, May 1999.
[6] United Nations Development Programme, Lithuanian Human Development Report 1998 (Vilnius, 1998).

the situation in the first half of 1998 and is based on the assumption that the average household with an average income will be purchasing a standard 2-room flat in Vilnius. As the available data suggest, there is a significant variation between the maximum and minimum price of units with different sizes (see **fig. IX**), however, house-price-to-income ratios remain high. Clearly, most new households will not be able to purchase housing without mortgage or other support. It should be noted that house purchase assistance must be carefully targeted. Given the mass privatization of the housing stock, most existing households wishing to move will have an asset to sell or rent out to generate net income. This needs to be factored into any assessment of affordability.

While new households clearly face affordability problems to access the homeownership market, housing costs in the public rental sector appear to be modest. According to time series data presented in **annex II**, rental housing is more affordable and on average housing costs -- rent together with utilities (fuel, electricity and gas) -- have fallen and constitute 14.4 per cent of total household expenditures. In 1998 these costs were higher for urban households -- 15.0 per cent -- and relatively lower -- 12.4 per cent on average -- for rural households. Local experts indicate that, for some groups, housing costs might be as high as 30 per cent, mostly due to increasing utility prices. Fees for hot and cold water and sewerage increased 14- fold in 1993-1998; heating costs 6.8- fold; gas and electricity 2.6- fold. It is estimated that about 20 per cent of the households in Vilnius have difficulties in covering utility costs, and if adequate maintenance were to be carried out up to 40 per cent of homeowners might have financial difficulties sustaining their status. [7] It has been suggested that official statistics related to income are not reliable and should be interpreted with caution.

Housing subsidies, taxes and allowances

The Lithuanian Government is under pressure to balance its budget and reduce public spending. Public financial support for housing is limited, although different types of direct and indirect governmental support related to housing have been introduced during the period of transition (**table 20**). Governmental Resolution 794 of June 1999 indicates a commitment to distribute funds from the General Fund for Housing Construction and Acquisition for the period 1999 - 2000 and to establish municipal housing funds. The aims of these funds are: (i) to promote the construction of new residential buildings; (ii) to facilitate the modernization of existing municipal housing; and (iii) to assist the purchase of dwellings at market prices.

Table 20. Main support schemes, 1997

	Type of support	Financial source	Amount allocated in one year (million litai)
BUSTAS	Subsidy element of soft loans	Extrabudgetary fund	17.7
Heat and hot water	Subsidy	National budget	230
Energy saving	Subsidy element of soft loans	World Bank loan & Lithuanian counterpart funding	1 (approximately)
Support for municipal housing acquisition	Grants	National budget	10 (in 1998)
Indirect support for municipal services	Hidden subsidy		250 (approximately)
Indirect support for tenants in public rental housing	Hidden subsidy		375 (estimate)

Source: Danish Ministry of Housing and Lithuanian Ministry of Construction and Urban Development, Study on Government Assistance Programmes to the Housing Sector (Vilnius, August 1998).

Though rents in public sector housing remain very low, rental subsidies are slowly shifting away from general support (available irrespective of income) towards personal, means-tested support. According to a draft law, 135 litai per person per month is the basis for calculating rent allowances. For households earning less than twice this amount per person, rent allowances are paid irrespective of the rental sector. However, rent allowance schemes are complex and have perverse incentives (including unemployment and poverty traps, the need to encourage households to find the lowest rents and the need to integrate with other welfare benefits). Similar

[7] Vilnius Municipality, A housing policy for the city of Vilnius, Proposal, p. 6.

observations can be made concerning energy cost allowances (especially the need to encourage households to use energy more efficiently) - a much larger subsidy in Lithuania, as energy costs have risen much faster than rents and are reaching world-market levels.

Property taxes can have a number of aims, including the raising of revenue (possibly earmarked for particular uses), the promotion or reduction of demand, or the promotion of equity. In Lithuania, the main taxes affecting housing include a tax on developed land, value-added tax on construction, a capital gains tax, and corporate taxes on developers, private landlords and homeowners' associations. These, and relief when offered, have a significant impact on the housing market, but this appears uncoordinated by the Government. For example, VAT is not levied on construction renovation or insulation work or the design of houses and flats funded from the State or municipal budgets. Furthermore, VAT may be reimbursed, but only to those entities that have registered as VAT payers with the State Tax Agency. Usually, physical persons or construction associations are not on the Register of VAT payers. Therefore, the VAT they pay may not be reimbursed.

C. Mortgage markets

Financial institutions and mortgage market infrastructure

One condition of mortgage market development - macroeconomic stability - has been met. In addition, Lithuania has positive economic growth, strict control over its public expenditure, low inflation and short-term currency stability. In this environment real interest rates are becoming positive whilst nominal interest rates are falling to levels where it becomes possible for potential mortgagers to afford the use of mortgage instruments and to service the mortgage with their incomes (see **table 21**).

Table 21. Average nominal interest rates and inflation
(In per cent)

Indicators	1993	1994	1995	1996	1997	1998	1999
Inflation			35.7	13.1	8.4	2.4	N/A
General government securities		21.43	27.48	20.46	8.90	11.18	11.87
Time deposits [a] in:							
Litas	90.40	48.43	20.05	13.95	9.01	7.44	8.07
Foreign currency	23.58	24.91	15.97	9.36	6.43	5.05	6.38
Loans [b] in:							
Litas	91.82	62.30	27.08	21.56	14.39	12.21	9.92
Foreign currency	68.70	51.98	26.93	21.63	12.39	10.28	11.11

Source: Lithuanian National Bank, January 2000 http://www.lbank.lt

a/ Data for 1997 and onwards refer to time deposits for 2 and more years. Data before 1997 refer to shorter maturity time-deposits.

b/ Data for 1999 refer to housing loans while the rates for other loans were slightly higher: 13.09% in litas and 11.46% in foreign currency.

N/A – not available.

A second important condition of mortgage market development - strong financial institutions - is in its infancy in Lithuania. The structure of credit institutions has developed (**table 22**). At the same time the State increased bank deposit insurance from 4,000 to 25,000 litai. Total borrowing from foreign financial institutions recently doubled. [8]

Table 22. Credit institutions, January 2000

Type of institution	Number of institutions
Deposit money banks	10
Other banks	2
Foreign banks branches	3
Foreign banks representative offices	4
Credit unions	33

Source: The National Bank of Lithuania, Credit institutions, http://www.lbank.lt

[8] Sources of information: LB: Statistics – Loans by Economic Activities, http://www.lbank.lt; United Nations Development Programme, Lithuanian Human Development Report 1998 (Vilnius, 1998).

The financial system is slowly becoming stronger. The banking sector started to recover in 1997 after the 1995-1996 crisis. The assets of commercial banks by the end of 1997 comprised 8.3 billion litai and increased by 40 per cent over the year. In 1999, the consolidated assets of banking institutions including commercial banks, foreign bank branches and credit unions reached nearly 12.5 billion litai. Services rendered grew by 18 per cent. The volume of loans grew 2.1- fold. However, relatively weak and inefficient private commercial banks continue to operate in the market. The Bank of Lithuania has not taken adequate action to speed up re-capitalization of these banks. They do not have sufficient funds to grow. Only two commercial banks have significant funds, the largest has assets worth some 2.5 billion litas, but is still oriented towards commercial lending. Commercial banks operate on a very short-term deposit base. Time deposits exceeding 6 months constitute only 12 per cent of the total deposits made. The majority of terms of deposit agreements vary from less than one to three months. [9] There are no specific housing savings banks/mortgagees and inter-bank lending is insignificant.

A major reason for the slow development of the banking sector is that most banking assets still belong to the State. By the end of 1997, close to 50 per cent of all banking assets were State-owned. During the reforms, three State banks were poorly managed and funds from the State budget (loans received on behalf of the State and privatization revenues) were used to cover the losses in the operation of the State banks. Despite political approval, the privatization of the State banks was postponed.

Traditional long-term investors in the mortgage market, such as private pension funds and life insurance companies, are also poorly developed, thus limiting the availability of long-term resources. A law on pension funds is under discussion in the Seimas. Its adoption may stimulate the development of long-term financial instruments. At the moment the major sources of long-term money are the State budget, an extrabudgetary Supporting Fund and governmental external debt. Long-term private sector debt does not play a significant role and in 1997 it was only 4.6 per cent of total external debt. Another financial institution that usually plays a major role in the financial markets are investment funds, but they are non-existent in Lithuania. Several joint-stock investment companies were reorganized into controlling investment companies, but they are very small and limited in their investment policy. Their number is declining.

The weakness of the banking and capital markets has hindered the development of a secondary mortgage market. Such a market can encourage the operations of the primary mortgage market by improving liquidity and diversifying risk. A stronger, more widely based set of financial institutions is also likely to allow longer-term and more varied (e.g. fixed rate, capped, discounted) mortgage products to be developed. However, a mortgage securitization system is currently being proposed. The basic objective is to assist the Lithuanian financial sector and capital markets to adopt the European Union's legislation and to support integration into the single market of the European Union. Within this context, Government policy relating to mortgage market development should be refined.

The third condition of mortgage market development - its infrastructure elements - has begun to take shape in Lithuania. With the privatization of the nation's housing stock, a real estate market has developed with the sale, re-sale and purchase of housing. The liquidity of the real estate market increased with the growth of new players such as real-estate agents and certified independent surveyors. Lithuania has a Central Real Estate Register and 15 regional offices. From April 1998 to March 1999, 28000 real-estate objects were registered as collateral valued at 7.5 billion litai, while loans granted were valued at 5.5 billion litai. [10]

In summary, many of the foundations of a mortgage market are in place - strengthening economic fundamentals, an improving banking sector and a real-estate market. Furthermore, the Lithuanian Government has indicated its intentions to expand mortgage lending. An agreement between the Danish Minister of Economic Affairs and the Lithuanian Finance Minister has been concluded with the aim of strengthening the mortgage lending system.

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[9] Data supplied by the Housing Credit Foundation, Vilnius, 1999.

Mortgage products

The Lithuanian Government is directly involved in retail mortgage activity offering subsidized mortgage products. This practice prevents the development of commercial mortgage lending and restricts its efficiency in terms of all-in costs and affordability to consumers. The Government continues to finance mortgages while commercial mortgage lending is just emerging. In short, the presence of the former may be hindering the development of the latter. So *the existing mortgage lending system consists of two separate sub-systems operating on different principles.* The first is through the State support programmes based on non-market principles and the second is from commercial banks based on commercial principles. A hybrid system, using Government guarantees, is in the offing.

In 1992, the Law on State Support for the Provision of Dwellings for Citizens was adopted. Residents can apply for a subsidized loan for the acquisition or construction of a house or flat. The main characteristics of the loans offered through the State programmes are presented in **table 23**. As discussed in section B (housing subsidies), these loans have highly subsidized interest rates and the Government pays part of the principal. They are available only to a limited number of people within the target groups. The General Fund for Housing Construction and Acquisition has approximately 300 million litai and does not make a profit.

Table 23. Terms of mortgages through the «BUSTAS» programme

Commercial banks	Savings Bank (former State bank) Vilnius Bank
Interest rate	5% annual rate; the difference with the market interest rate charged by the commercial bank is covered by the Support Fund.
Other terms	No interest for families on social benefits; 20% discount on principal for orphans; 10% discount on principal for families with disabled members; interest and discounted part of principal are covered by the General Support Fund.
Maturity	Up to 10 years for the purchase of a dwelling; up to 12 years for the construction of a dwelling (Savings Bank only).
Currency	Litas (Savings Bank only); US$ (both banks)
Loan-to-value ratio	Banks grant a loan up to 90% of the pledged property market value; the down payment varies from 10% to 30% of the dwelling value.
Required income level	Vilnius Bank: monthly mortgage payments shall not exceed 40% of family's net income; and 500 litai per family member shall remain after monthly payment on the loan. Savings Bank: monthly mortgage payments shall not exceed 40% of family's net income
Repayment	Vilnius Bank: monthly annuity repayment, monthly grace period. Savings Bank: dwelling purchase loan – up to one year's grace period; construction loan - 3 years' grace period for principal with quarterly payments; interest on both products paid monthly the month after the loan is granted.
Collateral and insurance	The dwelling shall be pledged and insured; life insurance for 30% of the mortgage.

In 1997, only 1,380 households were granted privileged loans through the State programme. Yet, nearly 8 per cent of all residents (some 90,000 households in urban areas) are registered for State support and it takes six to ten years to receive a loan. There is also a high drop-out rate between initial expressions of interest

[10] http://www.hytas.lt

and mortgaging. Funds allocated for this purpose from the State budget were insufficient even to meet the needs of those on benefit. The programme envisaged the construction of 65,000 flats between 1995 and 2000, or 13,000 per year. Meanwhile, during 1996-97 only approximately 11,000 flats were built.

A government-guaranteed mortgage insurance system is being developed. In 1999, the Housing Loan Insurance Company was registered with 7 million litai of capital and 95 million litai allocated for the purpose of eligible loans insurance. Mortgage insurance will be provided if the following conditions are met:

- Loans must be for house purchase, construction or renovation;
- 10 – 20 per cent down payments;
- 15-year maturity loans;
- Insurance premium paid up-front by the Government, with insurance fund taking 90 per cent risk and the bank 10 per cent;
- Principal and interest payments not exceeding 40% of household income.

In short, if households meet the eligibility criteria of the scheme and of the bank, then Government-backed insurance will be forthcoming. Households on the waiting lists will be eligible for Government-guaranteed mortgage insurance. The scheme is a welcome development, but a number of issues need to be monitored:

- Whether cost-to-value differences impede applicants;
- Whether Government, particularly the Ministry of Finance, is content to have an open-ended scheme, not cash-limited;
- Whether relatively low down payments impede the development of savings, sound credit histories, and wider mortgage market development;
- How far the availability of Government insurance impedes the commercial, including risk appraisal, approach of the banks.

There may be other means to stimulate the effective demand for mortgages. Part-buy, part-rent schemes and/or equity share schemes may allow some middle-income households to purchase housing at a modest cost to the public purse. However, they are inherently complex and may require further legislative change.

Table 24. Commercial mortgage financing offered by the major banks

Interest rate	9.5-13.5%
Term	No-longer than 10 years
Currency	Mainly in US$
Size of a loan	70% of a dwelling's market price
Required income level	Monthly mortgage payments shall not exceed 40% of borrower's income
Required income for mortgage: Loan size – 100,000 litas Interest rate – 11% Term – 10 years	Net family income should exceed 3,500 litai

Source: Data supplied by the Housing Credit Foundation, Vilnius, May 1999.

Commercial mortgage lending is not well developed. At present, only three commercial banks offer residential mortgages, although other commercial banks occasionally offer limited mortgage funds, often to their own employees. One foreign financial institution (the Baltic-American Enterprise Fund) has also started a mortgage programme lending US$ 5 million in residential mortgages. [11]

As in many countries in transition, the mortgage instruments offered by commercial banks are expensive in terms of high interest rates and short maturity. They are affordable only to high-income groups as

[11] Data supplied by the Baltic-American Enterprise Fund, Vilnius, 1999.

indicated in **table 24**. Usually the loan is denominated in a foreign currency because the local currency is considered to be overvalued. This currency risk further increases the borrower's risk and correspondingly leads to a low volume of mortgage operations in the private banking sector. Long-term residential mortgage lending is still considered by the private banking sector as particularly risky. To compensate, the banks have significantly increased their margin over the cost of funds they use to finance mortgages. The margin between the interest charged and one-year deposit interest rates varies between 5-8 per cent. In a well functioning housing market, the value of this indicator should be positive but with the housing loan rate only modestly higher than the cost of the funds (on average 1.5-2 per cent).

In summary, the risks associated with mortgage lending remain high and the private banking sector remains a reluctant mortgagee, preferring to lend to larger legal entities. *Indeed, although housing has been largely privatized in Lithuania, housing finance has not.*

D. Financing of maintenance and renewal

Maintenance and renewal of multi-family housing

Much of this previous analysis concentrates on increasing the development and financing of new housing production. However, even in periods of rapid expansion of the housing stock, the management, repair and improvement of the existing one remains central. Three factors compound this importance in Lithuania:

- Lithuania's housing stock expanded rapidly at particular periods in the 1960s, 1970s and 1980s using particular building forms and methods. These properties will age and suffer the same elemental failures at the same time;
- Multi-family blocks of flats, requiring special management and maintenance arrangements for common parts and common services (compared to single-family dwellings), dominate the housing stock;
- Mass privatization of the stock in the early 1990s was undertaken without a robust legal and regulatory framework. However, tenant/landlord relationships have to be replaced by client/contractor relationships with related organizational and financial changes.

First, there is a need for accurate information on the conditions of the housing stock. An accurate sample survey is a first step towards assessing current conditions and disrepair, the timing and the extent of future repair and improvement requirements and the costs.

Second, there is a need to examine ways of increasing the funding for house repair and improvement. Specifically, the following might be explored:

(a) The provision of 'sinking funds' built up over time to cope with future major repair expenditure;
(b) The need to develop home improvement equity loans;
(c) The need to develop some form of home improvement subsidy arrangements for the most intractable cost-over-value cases, particularly for those households on low incomes.

Third, and given the number of owners in individual multi-family blocks, there is a need to bring them together as single purchasing 'clients'. There has been some success in promoting homeowners' associations. These offer a range of benefits in the management, maintenance and improvement of multi-family housing. However, only 4,500 have emerged so far. There appear to be a number of financial and other means to further expand coverage through:

(a) The proposed legislative changes which do not require homeowners' associations membership but do require all households to abide by the decisions of properly constituted homeowners' associations;
(b) Tax incentives for homeowners' associations, perhaps through tax relief to individual households for sinking fund or other maintenance contributions;
(c) Making energy efficiency or other home improvement grants and subsidies dependent on the existence of a properly constituted homeowners' associations. The Energy Efficiency Housing Pilot Project of the World Bank offers grants and loans via homeowners' associations for energy efficiency improvements. Some 30 homeowners' associations have been sponsored in an 18-month period;

(d) Making the payment of fuel subsidies dependent on the presence of a properly constituted homeowners' associations;
(e) Making property maintenance subsidies, now available through municipalities and municipal maintenance companies, payable directly to homeowners' associations.

Maintenance and renewal of public housing

There are no available data on income and expenditure in public housing. However, following mass privatization the stock apparently contains older and often sub-standard units, scattered through different multi-family buildings. Low rents -- from 0.2 to 1.7 litas per m^2 per month -- do not allow cost recovery of management and maintenance work. The deficit between actual income and required expenditure is currently being managed by simply not carrying out the long-term maintenance work required. The backlog of repairs and improvements in public housing is increasing. While public-sector rent adjustment appears to be long overdue, it can be questioned whether it is appropriate to require the current tenants of public housing to bear all the costs of the mistakes of the past. There is uncertainty about their willingness and ability to do so.

A broad way forward for addressing the above gap between current income and required expenditure for maintenance and renewal is to gradually liberalize rents. Basic rent fees should take into account the depreciation from the updated procurement price of the flat, repair work and maintenance, and management overheads. Simultaneously with the first adjustment of the rent fees, it is necessary to provide subsidies for households with a low income.

Expanding rental housing

There will continue to be a number of new households unable to become owner-occupiers. Intervention, through some form of subsidy, will be required. This subsidy could be provided to increase the already, extremely high levels of owner-occupation. However, such an approach imposes high repair costs on households with low incomes, and may prevent reinvestment in the existing stock reaching sustainable levels.

An expanded and more vibrant rental sector is required. Any successful rental housing system should offer choices to households and a coherent rent structure and be regulated. This would allow landlords to be properly capitalized. In addition, the rental system needs to have revenue streams, covering at least operating costs, that is management, maintenance, and insurance costs. Within these broad parameters, a number of models, or more likely a number of combinations of models, are possible:

- The continuation and re-expansion of municipal rental housing;
- The design and promotion of a non-profit (or non-profit distributing) housing for rent sector (possibly community-based and/or aligned with expanded homeownership associations and/or municipal maintenance companies, once outside the municipal sector);
- The expansion, and where necessary the licensing and regulation, of the private, profit-making, rental sector.

In relation to these options the State will need to examine:

- The form of subsidy (capital or revenue; to producer or consumer, i.e. whether in the form of general – 'bricks and mortar' - or personal subsidies);
- The extent to which subsidy is to bodies outside public finance controls, which can lever private finance;
- The transfer of risk from State to private and independent sectors;
- The degree it wishes to regulate organizations operating in a subsidized market.

It is not possible to fully consider all these options in this report. However, they do need the attention of policy makers, landlords and financial institutions if the sector is to play its full role.