

A Sad Tale of a Housing Bank

By Elena Leontjeva, LFMI Consultant,
an article "Liudna pasaka apie busto banka"
published in the *Veidas* weekly of July 4, 2002

Elena Leontjeva discusses a proposal to adopt a housing finance system based on Bauspar loans and reveals the inefficiency and defects of such a system

Less than half a year has passed since the government abandoned its improper role of a banker, while attempts again are made to put it back where it was.

People have just started enjoying the first fruits of competition among banks, while plans are already being concocted to undermine it and to legalize privileges. Of course, no one calls for giving banks into the hands of the government or advocates against free competition. The changes are being orchestrated under a cover of nice banners carried by a crowd of respected and important people. But when one nice day these banners become a law, we will all be forced to carry them.

Questionable Saving

At first glance banners with the words "Helping People without Homes!" look attractive to everyone. After all, not every citizen in Lithuania yet may close a bank's door with a dreamed-of loan for housing, despite that competition among banks offers a unique variety of services and constantly falling interest rates. It's either the salary too low, or no money for the initial payment, or too many dependants in the family. Who will take care of all these people? That's why laws are drafted under which specialized housing, or Bauspar, banks will start operating along with commercial banks and will provide financing to those who are not able to take out loans in the market and who agree to save for themselves. This whole business will have to be subsidized by the government. However, just as you bring this banner down to the ground and feel it, you should sadly acknowledge that the privileged banks will undercut the competition in Lithuania's banking sector and cost a fortune to all taxpayers without realising the declared goal. Instead of being given a real opportunity to purchase a home of dreams, people will be embroiled in dubious long-term relationships with a privileged bank. Let me explain why.

Under the draft law, all those wishing to receive loans will first have to prove their thriftiness and solidarity. For two years in a row they will be obligated to put their earnings in a bank account until they accrue a specified amount, and only then they will be allowed to qualify for a housing loan. We are very well familiar with this principle of solidarity from the Russian folklore. Do you still remember the tale of the wolf, all frozen, hungry and beaten up by old village women, his tail torn off and stuck in a hole in the ice, who had the cunning and satiated fox sitting on his back and singing this song: "The unbeaten is riding the beaten!" Whatever nice words may one use to explain to people that they should contribute to the nation's savings plan and win the bank's trust, the essence remains the same: people who don't have money will not just be left without a housing loan but they will also be made to lend money to the one who has it – the bank. This is the first but not the only unpleasant surprise to people who are dreaming of purchasing an apartment or of building a house.

The second one is that the size of a loan is "tied" to the amount accumulated in a bank account. If an individual saves ten thousand *litas* over several years, he becomes eligible for a loan of the same size. But not for a larger amount, as the carefully drafted law restricts that. In other words, if an individual loans ten thousand *litas* to the bank, they will entrust exactly the same amount to him at the end of the savings period. However, such amount will be insufficient to buy an apartment, to say nothing of a house. Even if monthly earnings are rather considerable and an individual manages to save twice this size, the result will be disappointing all the same. Thousands of Czech residents have already become convinced of that, when after a fixed period of saving they eventually received the loans of their dreams. It became obvious that with such loans a saver had on average about 20 to 50 percent of residential property's price, the accrued amount in a bank account, interest and subsidies included. This means that he will have to keep looking for ways to buy an apartment. The situation is even more aggravated because an individual will have to mortgage his property to the Bauspar bank despite a meagre amount of the loan drawn from it. The law doesn't say what items an individual will have to offer to other creditors in order to earn their trust and get the missing part of financing.

Subsidies Spoil People

Certainly, there would be nothing wrong if a bank wished to create such a scheme of financing and had clients who trust it – this would be the matter of an agreement between them. Why was the law needed in this case? In order to legalize subsidies, which the government would have to pay to people for saving and interest rates paid by banks, lower than on the market. The bankers' argument that they will not gain anything from this is unjustified, because loans will be granted at lower interest rates than on the market. Even if the difference between interest received and interest paid is the same as when performing other banking operations, a bank will gain from this, as it will attract more clients by providing subsidies rather than competing in the market. Certainly, it may happen so that terms offered by banks competing in the market may be more favourable than those of the subsidized bank. The history bears witness to such cases. And yet, the mentality of "take when they give you" will encourage a number of clients to go to a place where something is given "for free". The subsidy is really considerable: twenty percent of the saved amount, but no more than five-hundred litas per year. Is this amount sufficient to attract quite a number of gullible people who would agree to be ridiculed and ripped off for this money?

The justifying argument is that the purpose of subsidies is to increase saving, "which is inadequately weak in Lithuania." This type of thinking poses a risk that some day we will hear such sayings as "Why should I get married, cook potato dumplings, weed my garden and bear children if the government does not subsidize me for this?" "If you want me to make a move, subsidize and pay for it." And what really makes me feel ashamed is to have to remind people, economists in particular, that in order to give a subsidy the government must get this money in the first place - either through taxes or in the form of a loan. This means that subsidized saving will increase at the expense of shrinking private funds, private borrowing and investments.

It is worth remembering the bizarre experience of the Czech people and other countries: individuals who didn't plan to purchase residential property kept their money in Bauspar banks just to get subsidies. After taking out the money together with a "free" gift from the taxpayers, they bought cars, had surgeries and went travelling around the world. As I mentioned before, the size of deposits is more suitable to buy such things than purchase a real residential property. Far-sighted Lithuanian politicians may boast that they have made trips abroad not in vain and that they have scrutinised the problem. That's why they propose paying subsidies only to those who would actually take mortgage loans. However, there's nothing to boast about here. Mending an unsound system does not make that system sounder, but it adds to the list of bad news. It means that a bank will successfully use the subsidy earmarked by the government each year until the time comes to issue a loan. However, many things may happen in between. For example, after overall calculations an individual may decide that taking a loan does not make any sense because it won't be enough to purchase an apartment, while he will have no other sources to borrow from (according to the statistics, most people will be confronted with this particular problem). Or an individual may search and find that he can get a larger and cheaper loan somewhere else. It may also happen that the bank itself will decide that someone does not qualify for its loan, for example, after a child birth in the family, or, putting it the red-tape way, families with the increased number of dependents, or if one of the spouses becomes disabled or if their earnings shrink. In all these cases an individual won't be able to get the promised and assigned subsidy, although he had kept his money in the bank at lower interest rates than on the market, thus giving the difference between them to the bank as a gift! One does not have to muse long to understand that after a long period of saving it will be lower-income people who will have lesser chances to obtain a loan, and this means that someone who was not beaten again will be riding on the back of someone who had been beaten badly.

The New Privileged

Not only a specialized bank may be eligible to the happy category of the "unbeaten". The law stipulates that an individual who has made a contract may obtain a loan prior to the prescribed minimal term of saving if, according to the distribution index, he falls into a specific group of clients. What an eldorado! While the unlucky ones will be painstakingly saving every penny and taking it to the bank, those from a special group of clients will be able to obtain loans right after signing a contract and not having had much time to accrue the required amount. The authors of the law may offer a lucid explanation that this grouping of clients is objective and designed to check their creditworthiness. Certainly, subjective evaluation does not become objective when squeezed into rigid indicators and formulas. The bank, all the same, will give a higher rating to a person with higher rather than lower income, with fewer rather than more children, i.e. dependents, and with a working rather than a disabled wife. This provides an open opportunity to discrimination against certain groups and legalizes favouritism. Moreover, an individual who takes out an early loan will also circumvent one of the system's most adverse restrictions, under which

the size of the loan may not exceed the amount accrued in a bank account. Without having accumulated anything, he will get the total amount specified in the contract!

I can already hear reproaches that client grouping and issuing loans to more creditworthy people are ordinary market principles, and it's ridiculous to argue against them. Of course, it is natural to apply them to people who borrow in the market, but promotion of such principles seems immoral when a special institution is created to provide loans to those who are unable to borrow under market conditions. If the goal of the new system will be to correct market imperfections and to seek noble social aims, it has to be done consistently, while the market, which has been renounced once, has to be left outside this issue.

Upon realizing all this, one may sincerely wonder how someone dares propose such a defective model to Lithuania, especially when it's common knowledge that specialized Bauspar banks in other countries faced a complete fiasco and that some of them are undergoing liquidation or litigation? I guess it would be difficult for the government to give a reply. And there are even more difficult questions. Although housing lending in the market has strengthened, some other long-awaited moves have not been made yet, e.g. legalization of a variety of banking institutions and services and issuance of mortgage-backed securities. It is these moves that would pave the way for housing loans and make them considerably cheaper and not require any subsidies from the society. The only thing that needs to be done here is utilizing resources allocated for legislation in a consistent and wise manner. One needs to learn a lesson from the painful and deplorable experience in rallying a number of government institutions and their efforts for the project inspired by a private bank. A lot of scarce resources, the most important of them being time rather than money, have been wasted this way. To acknowledge the mistakes would be a significant and welcome action. However, to avoid future plans to compete through the government, someone from the Administration should announce loudly that the last state-owned bank in Lithuania has been privatized and that from now on the Lithuanian government will no longer engage in the role of a banker but rather take care of its legitimate and proper duty – the adoption of prudent regulations.

Certainly, one should remember the lessons from the folklore here. In the said tale, when asked by the wolf about the kind of song he was singing, the fox replied boldly: "The unbeaten is riding the beaten!" With a sad smile on his face, the wolf said: "That's true", and hastened his pace.