

Comments on the Bauspar System and Proposal for Lithuania

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I first studied the Bausparkassen system in 1991, when I did an in-depth study of the housing finance systems in Germany, Denmark, France, the UK, and the US. I was very intrigued by it. It is seen as an important part of housing finance in Germany and Austria, but at that time, it existed nowhere else, and had been in a long-term decline in Germany.

It was started in Germany as a response to the terrible hyperinflation of the 1920s. The goal was to insulate the rate on housing loans and provide a stable source of funding for them. The idea seems pretty simple. Everyone agrees to be paid a low rate on their savings, and, if they save steadily over a long enough period, they would get a loan at a low rate for a period about as long as the savings period. In that way, if the flow of funds into the system stayed steady, there would be enough funds to provide a similar stream of loans out at the end of the savings period.

I don't really know much about the way the Bauspar system operated during the Nazi period, but after the war, it was seen as a source of the stability that Germans craved and it was heavily subsidized. And, in that time, before there were any credit records, it was also seen as a way of proving the moral character of potential mortgage borrowers, by requiring regular saving over a long period.

There is no doubt about its popularity in Germany and Austria. Most Germans and Austrians not only have a Bauspar account, but also open a new one up as soon as the existing one is complete. Not only is the rate of return on the savings higher than on the market (because of the state subsidy), but there is always a use for the low-rate loan. It becomes part of the financing to buy their first house, and then maybe a larger house, and then maybe a vacation house, and then also for renovations and repairs, and then finally also loans for their children and even grandchildren. It is part of their way of life.

But the German government did steadily cut down on the subsidies to the Bausparkassen, and even talked about ending them. Because of the limits placed on the subsidies, the amount saved became very small compared to the cost of houses in Germany, and by 1990, only about 10% of the credit for housing in Germany was given out by Bausparkassen.

But almost every house purchase does involve a Bauspar loan, of course always with a larger regular loan. Why? Because it is subsidized. Few people will pass up free government money. But to an outside observer like I, if the Bausparkassen disappeared, there seems that there would be no impact on the housing or mortgage market in Germany.

So as of 1990, many people, even in Germany, thought that the Bauspar system was mostly a nice piece of German tradition worth preserving, sort of like cuckoo clocks and lederhosen.

Then came the fall of Communism, and one of the first business groups to become active in the formerly Communist countries were the Bausparkassen. They saw conditions of high inflation and unstable financial systems, and felt that their system would be helpful.

It did not hurt that they also saw big opportunities for profits as well. Because when the market interest rates were 20-30%, if you can get people to save with you at 3%, you are making a nice 20% or more margin. Remember that the Bausparkassen are private, profit-making institutions, so this was attractive.

But all of these countries in transition were feeling poor and had troubled banking sectors, and the governments were in no mood to set up a new complex financial system involving unknown subsidy amounts, and so did not pay much attention to the Bauspar idea. But the public was very upset about the high interest rates or impossibility of housing loans and their elected Parliamentarians were an eager audience. Thus, in all four principal Central European countries sitting next to Austria and Germany, it was Parliamentarians, not the government, who were inspired by the Bausparkassen and initiated laws to set them up. Actually, in Poland, it was the President himself, but again not the government, who was initially convinced of the merits of a Bauspar system.

The first to get through was in Slovakia, where Bratislava is only 45 minutes from Vienna. A bill already passed in May of 1992, and the system started up a few months later. The Czechs started their system in 1993. The Hungarian government resisted the system harder, but eventually gave in in 1996. Meanwhile,

the biggest prize, the Polish market, was proving the hardest, with strong battles with the Parliament because the government refused to implement the law after it was passed.

I understand that the idea was also pushed here in Vilnius around 1992. If any of you have ever heard the arguments as they are made by the proponents of the Bauspar, the system sounds like a perfect situation where everyone wins. But the government at the time suspected that maybe there would be a loser, and that would be the budget. So it was not taken up then.

I really do not know why the idea has appeared again in Lithuania. In fact, I am hoping to find out today. Things have changed enormously since 1992. Inflation and market interest rates are quite low and the banking sector is quite stable, and is busy making housing loans. Yet the situation seems to be oddly the same as in the other countries in 1992, with Parliamentarians leading the way and the government resisting.

I tell this background for one reason. Almost unanimously, experts, even in the Central European countries that have adopted Bauspar systems, are not happy with them. The same holds for Ministers of Finance or Construction and Housing. Despite this, the Bauspar idea attracts strong political and popular support.

The question is why is there such a split between the "experts" and the public and politicians. Or, for that matter, a split between Germany and Austria and other housing systems everywhere else in the world, who have always gotten along just fine without the Bauspar system.

Now the full answer to that question would take much more time than I have. The simple but arrogant sounding answer to the first question is that Parliamentarians and the public do not understand the way the Bauspar system works, and the experts do. Consequently, some people see the traps and the others do not.

But in the time I have I want to show three things. (1) Why the public likes the Bauspar system. (2) Why banks, especially big banks, like Bausparkassen. And finally, (3) add a little more to Andrius' points about why policy analysts dislike them.

Why does the public like the Bauspar system? To the public, it sounds like a wonderful but sensible deal. They get a reward for saving, but only if they do so steadily over a long period. That reward consists of a bonus paid each year by the government, sort of like getting a medal for good citizenship. The effect of the bonus that is provided in the current draft of the law, 20%, is to give the saver who saves for 5 years a net tax-free return on their savings of 9%. That is a lot higher than any other guaranteed investment option and is a good incentive to tie up your funds for 5 years.

Now if the law is modified, as most recently proposed, to allow only a 2 year saving period, then the net interest rate to savers will be 16%.

As an aside, let me note that, although the latest draft of the law indicates that the saving period may be only 2 years, this is not really possible. Not only does the interest rate on the savings get very high, but the system becomes pointless. For the system to work, the repayment period must be very similar to the savings period and the loan amount about the same as the savings amount. So having a savings period of 2 years means that the repayment period will be only about 2 years and the amount that can be borrowed is very small. Such short savings and repayment periods are not very practical when borrowing for "high ticket" items such as a home. So, all of my discussion assumes that the saving period will be 5 years, as it is in the Czech Republic. It is 4 years in Hungary and 6 years in Slovakia. And 7 years in Germany.

In addition to earning 9% on your savings, you get to take a loan for a rate of only 6%. Now that seems not so low at the moment, but most people expect rates to go up again to 7% or more, so it is probably a good deal. But if it is not, that's OK; they get the 9% on their savings. There is one catch to this attraction ... to get the state subsidy, the savings amount must be used for housing. No loan has to be taken, but at least the savings amount must be for housing. But this in reality is not a problem, since it can be used for any housing-related purpose, including the payoff of a regular housing loan, or the housing expenses of a close relative.

So the public thinks it is great as long as they do not realize that the state budget, and therefore the taxpayers themselves, are to pay for this attractiveness. What about the banks participating in this system? There are two main advantages to the banks. First, they only have to pay 3% on the savings and on the state subsidy they collect from the budget on behalf of the savers. The state subsidy raises this to a return of 9% to the saver, if he or she finishes the contract, but the bank only pays 3% on these funds. Once again, in Lithuania at this time, that is not so cheap, but it probably will be cheap again in the future as the current excess liquidity goes down.

Now one would think that the Bauspar banks are not making any big money because they have to make loans at 6% after 5 years. But the fact is that they are not going to make many such loans any time soon. In the Czech Republic, after 8 years of operation, the Bausparkassen have made low-rate loans totaling only 7% of their deposits. Consequently, the other 93% of the Bauspar savings deposits were free to be invested in high-return market-rate investments. This has generated very high profits for their private owners of the banks.

In fact, in this case and in most cases, the Bausparkassen use most of the funds for making mortgage loans at market level regular rates to their clients, who then pay that high rate loan off with the Bauspar savings plus the low-rate loan after the full 5 years. If this is a surprise to anyone here, I would suggest that you are like most people. Usually the only people who really understand the inner workings of the Bauspar system are the Bauspar banks themselves. It is quite a complex situation.

Let me repeat. The main activity of Bausparkassen in their first 10-15 years of life is to make market-rate regular mortgage loans, called "advance loans," to their clients who don't want to wait for the full 5 years, just the 2 years required in the law. Of course, this activity could be done by regular banks. So there is zero benefit of any kind for at least 5 years.

An extra attraction to the banks is that the Bauspar law exempts Bauspar deposits from any requirement that the bank keep part of the funds on reserve with the Bank of Lithuania. This requirement is imposed on all other banks except the Bausparkassen. And note that any customers who do not ever save all 60 monthly savings never get the low rate loan or the state subsidy collected by the Bauspar bank on their behalf. But the bank gets to hold on to their money and any state subsidy, paying only 3%, until the failed depositor finally gives up and ask for their money back.

So the Bauspar banks can make big money. But there is an extra added bonus for the mother banks. The mother banks can tie down their customers and prevent them from shopping around for their regular housing loan. Once you start an account at a given Bauspar, you must keep it up with that institution until you have made your 60 monthly payments. That's why in Hungary, the biggest bank went all out to sign up as many people as possible the first year. And they have used their Bauspar to solidify their position in the market. In effect, the biggest banks today get a special way of tying in their current retail customer base for at least 5 years, making it harder for competitors to take them away. Needless to say, this is not the way to promote competition and more efficiency in the banking sector.

OK, the public wins, and the banks win. Why are the policy analysts in these countries so troubled? Mostly because the burden of the Bauspar system on the government budget just grows and grows over time. In the Czech Republic, it was only 0.5% of the total government budget in 1996. But double that three years later, in 1999, and it will be close to 1.4% this year. Why? Because more and more people sign up and they put in more and more savings, especially as the rate of interest on regular savings accounts has fallen. The best guess as to where it might stop is about 2% of the budget, which in the Czech Republic would be about 0.6% of GDP. No small amount!

What bothers people like me is that this is money that could have been used for other housing programs, which would be less expensive ways to achieve the same strategic objectives for housing.

I am sure that there are some people who will get a needed boost to their savings as well as a low rate loan. But let me point out that they do not get a larger loan than they would from a regular bank. If anything, it is a smaller loan. Why? Because it must be repaid over 5-6 years, not 20-30 years.

Let's think about who will get the bulk of the subsidies. It goes to higher income people who can save the maximum amount regularly for 5 years and who would usually qualify for a loan at the regular rate to begin with. Don't be misled by the limit of 2500 litas in savings each year that get the bonus. That is per person in a family. Better off families can put in 5000 or 10000 litas. How? One account for each parent and each of two children.

But a housing purpose is required to get the bonus or a loan. But the purpose is often for vacation homes or new kitchens and bathrooms. Or a bigger house. These are hardly the most important strategic objectives for the housing policy interventions using scarce public budget resources. Many of these people do not need the subsidy, and some may not even need the loan but they will take it if it is cheap enough, so that they free up their other money for consumption of cars, home electronics, consumer durables and other non-essential commodities.

So let me summarize what is disquieting about this situation to housing finance analysts and government policy makers:

1. The annual subsidy amount paid out by the budget is essentially out of control of the government. There is no way to cut it back if a budget crisis comes, because it is a legal commitment applicable to all existing contracts.

Either the Budget has to be 1-2% larger than otherwise or funding of other programs, including more effective and targeted housing programs, has to be cut back.

3. There is no or little effect for 5-10 years. Almost no impact on housing problems for at least that long, which can be verified in the countries in Central Europe that adopted the system.

4. As this law is written, the parameters of the program can not be modified without changing the law. So they are unlikely to be changed. At a minimum, the calibration of the system should be left to the government and not fixed in the law.

5. If the size of the subsidy is cut back, the scheme may become unstable, with new inflows of savings being too low to fund loan commitments. The system requires a constant flow of new people to meet the commitments made to earlier people.

6. A significant part of personal savings is sidetracked out of the normal financial system.

7. Much of housing finance is sidetracked away from the normal mortgage market.

8. Much of the subsidy is wasted in additional administration and marketing, plus, of course, the profits of the Bausparkassen. It is certainly an indirect and expensive way of getting a subsidy from the government and into the pockets of ordinary people.

The Bauspar system offers no magic. It is a system for delivering subsidies to housing through a private for-profit financial intermediary. It should be looked at in that manner. Is it efficient? No. The subsidy is being channeled through an expensive separate banking system, with large chunks being taken out by the banks. Is it targeted to those who need subsidy? No. If anything, most of the subsidy will go to relatively economically well off people who can save and borrow the most anyway.

Does it solve housing problems? Maybe a few, but mostly it is a windfall for the upper middle class and the banks. And, saddest of all, it costs so much that it denies real solutions to real housing problems for those who most need the help. And the system, once started, is almost impossible to stop or change, regardless of changing priorities or the macroeconomic situation of the country. These are the major reasons which explain why so few countries in Europe and elsewhere have consciously decided to adopt this system instead of other programs and instruments of housing policy.