

**A. Housing demand and the availability of housing financing**

*Investment in housing*

As already mentioned in this study, the period up to 2008 was very successful for Azerbaijan in terms of macroeconomic development and poverty reduction, but macroeconomic growth was mainly driven by the oil and gas industries as well as the construction of transit oil and gas pipelines through the country.<sup>41</sup> Significant growth in income (e.g. 138 per cent in 2008, and 140 per cent in 2007), which exceeded inflation (121 per cent in 2008, and 117 per cent in 2007), created an overwhelming demand for housing both in terms of renovations and new construction. The housing stock per capita is extremely low compared to developed countries, only 12.5 m<sup>2</sup>.<sup>42</sup> A notable percentage of buyers invested in housing to protect savings from inflation,<sup>43</sup> to have a residence upon returning from abroad or to provide separate housing for children. Increased uncertainty in the housing and mortgage markets in 2009 led to a relative decline in investments in housing.

*Investment in construction*

Residential construction has grown steadily in the last five years, as has investment in housing production. However, public investment in housing at the national and local levels did not exceed 15 per cent.<sup>44</sup> A lack of available mechanisms facilitating the construction of affordable housing, including the lack of available housing financing, resulted in a recent modest increase in the housing stock, which has only kept pace with population

growth.<sup>45</sup> Apartment construction has been mostly concentrated in the three largest cities (Baku, Sumgait and Ganja) and is primarily targeted towards the luxury segment of the market. In 2007, Baku alone counted for 30 per cent of the total housing construction in the country.<sup>46</sup> By contrast, less than 30 per cent of construction is undertaken in rural areas.<sup>47</sup> Given this situation, self-built housing becomes the easiest and most affordable way for the population to improve their housing situation. In 2008, individual housing built by tenants made up 60 per cent of the total housing output.<sup>48</sup>

According to market price dynamics and experts' estimates, there is an overwhelming demand for new and affordable multi-storey housing, but the supply of such housing stock is insufficient due to a lack of financial mechanisms supporting construction companies. Residential construction is financed mainly from the savings of future unit owners through their participation in housing construction cooperatives or through the pre-sale of future dwellings by the developer. In practice, the two operations are similar, but housing construction cooperatives are treated as non-profit organizations and are exempt from profit tax and VAT.

Lower housing prices at the beginning of construction (usually 30–40 per cent of the price of a completed apartment) are more attractive to buyers, despite the fact that no legal protection of their rights is provided. The registration of rights to

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<sup>41</sup> Central Asia Housing Finance Gap Analysis. IFC, 2006, p. 16.

<sup>42</sup> Data of the State Statistical Committee of the Republic of Azerbaijan ([www.azstat.org](http://www.azstat.org)).

<sup>43</sup> According to the Baku Realtors Association during last 12 years house prices have risen by 9 times, while overall prices (CPI) have increased only 1.9 times.

<sup>44</sup> Data provided by State Statistical Committee of the Republic of Azerbaijan in May 2009.

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<sup>45</sup> According to data of State Statistical Committee of the Republic of Azerbaijan, housing stock increased by 12.7 per cent from 2000 to 2008. At the same time, the increase in population was 8 per cent. As a result, housing stock per capita increased from 12.3 m<sup>2</sup> in 2000 to 12.5 m<sup>2</sup> in 2008.

<sup>46</sup> Data of the State Statistical Committee of the Republic of Azerbaijan ([www.azstat.org](http://www.azstat.org)).

<sup>47</sup> Data provided by State Statistical Committee of the Republic of Azerbaijan in May 2009.

<sup>48</sup> Ibid.

**Table 5. Number and volume of housing constructions by sector**

Year	Public sector		Private sector	
	Number of apartments (in thousands)*	Volume of construction (in thousand m <sup>2</sup> )	Number of apartments (in thousands)*	Volume of construction (in thousand m <sup>2</sup> )
2004	0.3	41	11.9	1 318
2005	1.9	176	13.8	1 417
2006	1.4	146	12.5	1 437
2007	2.8	236	11.9	1 380
2008	2.5	243	14.6	1 602

\* Calculated using the reported volume of construction and average size of constructed unit.

Source: Data provided by the State Statistical Committee of the Republic of Azerbaijan in May 2009.

unfinished buildings is possible, but not a common practice. The lack of protection of consumer rights in the housing sector leads to a lower quality in the dwellings constructed and delays in the fulfilment of developers' obligations.

Residential construction financing by commercial banks remains low,<sup>49</sup> reportedly due to the significant risks involved. However, before 2009, banks were likely to provide short-term loans (two years) to developers at high rates (more than 30 per cent) because it was a very profitable sector (especially the luxury segment).

Usually, property belonging to the developer or its owner was used as collateral. The global financial crisis has seriously affected investment in construction by stabilizing housing prices. Pre-financing schemes no longer work, as buyers cannot benefit from price increases over the period of construction and demand for housing has declined. Many developers facing liquidity problems have frozen construction or are not starting new projects. This situation heightens the risk that developers will fail to finish construction of already sold units.

### ***Rental sector***

The Government has no policy for developing the rental housing sector. According to the Housing

Code,<sup>50</sup> the Government is responsible for providing rental housing to households in need, but such dwellings can still be subject to privatization, so only 12.3 per cent of the total housing stock is public.<sup>51</sup> Demand for rental of moderate housing significantly increases its supply, especially in large cities, but the private rental sector mainly serves foreigners. Major obstacles to the sector's development are (a) the absence of protection of both renters' and landlords' rights, (b) the ban on renting units to refugees, and (c) inefficient taxation of profits. (A profit tax of 14 per cent is supposed to be paid by renters, but in the case of foreigners this becomes the responsibility of the landlord.)

### ***Existing housing stock and access to housing financing***

After the mass privatization of State-owned residential dwellings in the 1990s, there was significant underinvestment in housing maintenance. The Government's obligation to maintain privatized dwellings ceased, but most apartment owners have not been able to afford maintenance of their units. Moreover, even if a dwelling is privatized, the Government still owns the building itself (roofs, walls and common spaces) and the maintenance of common areas should be performed by the State. This prevents competition between maintenance companies. As

<sup>49</sup> In 2008, outstanding credits to construction and real estate sector were 461 million AZN (6.4 per cent of total credits, or 1.2 per cent GDP)

<sup>50</sup> Housing Code of the Azerbaijan Republic, adopted on 8 July 1982.

<sup>51</sup> This figure also includes housing stock that belongs to housing construction cooperatives and public organizations. Data provided by State Statistical Committee of the Republic of Azerbaijan in May 2009.

IFC has noted,<sup>52</sup> State organizations have limited financial resources and lack sufficient capacity for repairs and maintenance. The servicing fee is generally too small and is often not understood by tenants. The experience of housing cooperatives in the maintenance of the common areas of multifamily dwellings is still limited. Such cooperatives are generally created for new housing construction and are seriously hampered by the absence of legislation establishing a framework for their operations.

### ***Relationship between housing policy and housing financing***

The absence of a State institution responsible for housing policy also contributes to a lack of coordination of housing-related programmes and their funding. Some government organizations finance housing construction for their employees and specific categories of households (e.g. refugees and forced migrants, veterans, and young families).

During 2004 and 2005, the Government established a set of important measures intended to improve housing conditions for a wide spectrum of the population. The main results were the Law on Mortgage and the establishment of the Azerbaijan Mortgage Fund (AMF) in 2005. The main functions of AMF are:

- Refinancing mortgage credits disbursed by authorized credit organizations;
- Developing standards for residential mortgage lending;
- Issuing mortgage-backed securities to attract additional long-term funds for mortgage lending;
- Managing financial risk in mortgage lending through the provision of long-term funding to achieve stability and liquidity.

The Government has already invested 68 million AZN in AMF mortgage programmes, but due to the overwhelming demand for heavily subsidized mortgages,<sup>53</sup> the Fund ran out of money

in May 2007 and the programme was suspended. In 2009, the programme was resumed with a commitment by the Central Bank of Azerbaijan to develop the mortgage industry. AMF issued 55 million AZN covered bonds and the Government provided an additional input of 14 million AZN for subsidizing mortgages.

### **B. State and local governments and ways housing finance is generated**

For local government, which shares responsibility for the design and implementation of housing policy with local executive authorities, financial resources are very tight and often sufficient only for performing basic administrative duties. Thus, virtually no local authorities have housing programmes. Local budgets are prepared locally, but are dependent on transfers from the State budget, the only way to cover the budget deficit (about 62 per cent of total local expenditures are financed through transfers from the State budget<sup>54</sup>). Distribution of tax revenues between State and local budgets is complicated. Municipalities have their own tax collection services.

#### ***Land and property taxes***

Land and property taxes are the main sources of revenue for local budgets, but taxes collected from legal entities go directly to the State budget. The lack of a cadastral valuation system is an obvious drawback. The land tax stipulated in the Tax Code varies according to the size of the city. It ranges from 0.1 (in rural areas) to 0.6 (in Baku) by AZN per 100 m<sup>2</sup> for land, and in terms of housing, 2–8 AZN per 100 m<sup>2</sup> for land for construction and non-agricultural purposes. For agricultural land, the tax is calculated according to normative values of land based on different multipliers (coefficients), determined by the State. All land users (except the State and local governments) are subject to taxation.

Property taxes paid by individuals are another source of revenue for local governments, but at present these are based on normative values far

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<sup>52</sup> Central Asia Housing Finance Gap Analysis. IFC, 2006, p. 17.

<sup>53</sup> Mortgages were provided for 3–25 years at 6–8 per cent per annum. LTV was up to 85 per cent, and PTI was up to 70 per cent, with no restrictions on OTI. The maximum size of mortgage was 50,000 AZN. For

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several categories of households (e.g. young families, the military), the interest rate was 4 per cent per annum.

<sup>54</sup> Law on State Budget of Azerbaijan Republic for 2009. N 715-IIIГ, 25 November 2008

below market rates. The tax rate is determined by the Tax Code, at 0.1 per cent of the property's value. Legal entities have to pay a tax of 1 per cent of the property's value. A real estate and land mass market-based valuation system was planned to be implemented by the end of 2009 with the technical assistance of the World Bank through the Real Estate Registration (RER) project. Under current legislation, the situation with common areas in multi-unit dwellings is not obvious. While the owners of units actually use these common areas, formally they belong to the State or to a legal entity created by the developer; in practice, these areas are not subject to taxation.

### *Land sales*

Earnings generated by selling land plots for construction could provide sufficient funds for housing policies. However, no obligation has been placed on local governments to use the income generated from the sale of land for housing purposes. According to current legislation, starting in 2007 all allocations of land must be done through tender procedures (except State programmes when land should be allocated free of charge)—but still subject to subsequent approval by the Government. By the beginning of 2009, only two tenders had been completed because of the late adoption of tender procedures, so it is too early to evaluate the effects of tenders on housing finance.

### *Taxation of construction and sales of units*

In 2007, a special State tax was introduced on the construction of multifamily dwellings. When a developer starts construction work on a site, that developer must pay a tax of 5–50 AZN per m<sup>2</sup> of floor area to be constructed for sale. (This depends on location, i.e. it is the lowest in rural areas and the highest in central Baku). The tax should be paid through equal instalments, on a quarterly basis over two years. In addition, the developer, like other companies, must pay VAT (18 per cent) on the proceeds of the sales of units as well as profit tax (22 per cent) and property taxes (all of these go to the State budget). In 2008, the Cabinet of Ministries adopted minimum prices for housing units for VAT taxation purposes. The minimum price is calculated at 225 AZN per 1 m<sup>2</sup> of housing multiplied by the regional coefficient (which range from 0.6 in rural areas to 3.5 in Baku centre). Revenues from housing transactions are subject to

profit tax, except when selling a unit that has been one's primary residence for more than three years.

### *Overview of the banking sector*

The banking system in Azerbaijan is represented by 46 commercial banks, of which 14 have a share of foreign capital of 50–100 per cent.<sup>55</sup> The country has quite a high sovereign rating (BB+) from international agencies such as S&P and Fitch. A number of the leading banks also have good ratings from such international agencies. The banking sector is fully implementing *International Financial Reporting Standards* (IFRS) principles, and has experienced healthy growth in recent years. Total assets increased from 2.3 billion AZN in 2005 to 10.2 billion AZN in 2008,<sup>56</sup> although 40 per cent of all assets are controlled by State-run banks.<sup>57</sup> Mortgage loans currently comprise approximately 1.2 per cent of total banking assets.<sup>58</sup> The banking sector is fairly profitable, with an average return on equity (ROE) of 10.8 per cent.<sup>59</sup>

The depth of the banking sector has likewise increased. As a percentage of GDP, total banking sector assets almost doubled over six years (from 14.3 per cent in 2002 to 27 per cent in 2008). Bank deposits as a percentage of GDP increased by 50 per cent, indicating an increase in confidence in the banking system. Moreover, in 2007, a State deposit insurance system was created with the guarantee of 6,000 AZN per deposit,<sup>60</sup> but now the idea is to increase it to 30,000–50,000 AZN. Long-term funding, especially from local sources, is limited: domestic deposits do not usually exceed 2 per cent per year, about 50 per cent of all assets are short-term, and 70 per cent of the banking system's resource base has a maturity of less than one

<sup>55</sup> *Statistical Bulletin of the National Bank of the Republic of Azerbaijan*, 3/2009, table 4.2.

<sup>56</sup> *Statistical Bulletin of the National Bank of the Republic of Azerbaijan*, 12/2006, table 4.2.

<sup>57</sup> Data provided by National Bank of the Republic of Azerbaijan staff in May 2009.

<sup>58</sup> *Ibid.*

<sup>59</sup> Calculated using data from *Statistical Bulletin of the National Bank of the Republic of Azerbaijan*, 3/2009, tables 4.2 and 4.4.

<sup>60</sup> *Law of the Azerbaijan Republic "On deposit insurance" N226-IIIQ*, 29 December 2006.

**Table 6. Assets and deposits of the Azerbaijan banking sector**

	2002	2003	2004	2005	2006	2007	2008
<b>Assets</b> (in million AZN)	849	1 047	1 706	2 252	3 778	6 726	10 237
<b>Percentage of GDP</b>	14	15	20	19	21	25	27
<b>Deposits</b> (in million AZN)	546	630	1 049	1 381	2 233	3 438	4 055
<b>Percentage of GDP</b>	9	9	12	12	13	13	11
<b>Share of deposits in foreign currency</b> (percentage)	84	82	80	81	61	47	55

Source: National Bank of the Republic of Azerbaijan (www.nba.az).

year.<sup>61</sup> Without sources of long-term capital, growing capitalization remains insufficient to fund mortgage lending, particularly in view of high property prices.<sup>62</sup>

In 2008, the average interest rate on bank loans for households was 21 per cent for local currency loans and 22 per cent for foreign currency loans.<sup>63</sup> The total volume of credits to households is about 32 per cent of the total volume of credits and 6 per cent of GDP. Despite such unaffordable rates, the volume of credits to households increased by 40 per cent during 2008 (from 1.657 billion AZN in 2007 to 2.335 billion AZN in 2008). The interest rate on deposits was 12.5 per cent for both local and foreign currencies, far below inflation (20.8 per cent). Due to increased uncertainty with respect to the financial and commodity markets, commercial banks have excessive liquidity, but stick to “wait and see positions” and issue practically no loans.

There are about 77 credit unions and 32 microfinance institutions (MFIs) operating in the country.<sup>64</sup> Unlike banks, credit unions generally do not have the right to accept deposits, so they refinance loans through shareholders’ equity or refinancing facilities offered by international

donors. MFIs lack the special legislative environment that could create a more effective framework for their operations. MFIs have about 320,000 clients with an outstanding loan portfolio of more than USD 500,000,<sup>65</sup> but only MFIs sponsored by international investors have the capacity to extend their services.

### *Mortgage market*

Development of the mortgage market in Azerbaijan began in 2005 with the adoption of the Law on Mortgages.<sup>66</sup> The Law established a legal framework for mortgage lending, including the possibility of using unfinished buildings as collateral. The Presidential Decree “On the Establishment of the Mortgage Lending System in the Azerbaijan Republic”<sup>67</sup> defined a basis for simplifying the mortgage registration process and for preparing the Law on Savings and Construction Banks (still under discussion); it also created a State mortgage refinancing facility (AMF).

The mortgage market has grown significantly since 2005, albeit from a low base. Currently, the mortgage loans outstanding in the banking system come to approximately 217 million AZN (less than 1 per cent of GDP and 2 per cent of the total loan portfolio)<sup>68</sup>. The number of mortgages registered in 2008 totalled 17,700, which is about 15 per cent of

<sup>61</sup> Annual Report of the National Bank of the Republic of Azerbaijan, 2007, p. 67.

<sup>62</sup> The average price for a two-bedroom apartment in Baku is USD 75,000. Thus, the total bank equity of USD 2.2 billion could hypothetically finance a maximum of about 29,000 apartment units.

<sup>63</sup> *Statistical Bulletin of the National Bank of the Republic of Azerbaijan*, 3/2009, table 3.2.

<sup>64</sup> Data provided by National Bank of the Republic of Azerbaijan and Azerbaijan Micro-finance Association staff in May 2009.

<sup>65</sup> Data provided by Azerbaijan Microfinance Association in May 2009.

<sup>66</sup> Law on Mortgages, N883-III, 15 April 2005.

<sup>67</sup> The Presidential Decree “On the Establishment of the Mortgage Lending System in the Azerbaijan Republic”, N299, 16 September 2005

<sup>68</sup> Data provided by National Bank of the Republic of Azerbaijan in May 2009.

total housing rights turnover,<sup>69</sup> and IFC estimates that there is substantial room for further growth of the market.<sup>70</sup> The State-supported mortgage programme launched by AMF at the end of 2006 created the necessary bases for development of the mortgage market.

Under the programme, the Central Bank of Azerbaijan selects banks who act as agents of AMF in issuing mortgages. The interest rate for the borrower was up to 8 per cent, of which AMF receives 4 per cent. There were no limits on banks' issuance of mortgages, which in combination with the high demand has led to AMF unexpectedly running out of money in May 2007 and being unable to purchase all mortgages issued by participating banks. In 2007, the conditions of the programme were changed by a Presidential decree: the term was increased to 25 years, the loan-to-value (LTV) up to 85 per cent, the PTI up to 70 per cent. No restrictions were set on DTI. The maximum size of a mortgage was set at 50,000 AZN. For several categories of households (e.g. young families and public servants, academicians, refugees and IDPs, as well as certain military personnel), mortgages were provided at 4 per cent interest rates. Before liquidity problems occurred, AMF had refinanced mortgages totalling about 62 million AZN, of which 92 per cent were issued in Baku city.<sup>71</sup>

Before the world financial crisis, a few banks offered their own mortgage programmes, but could not compete with the heavily subsidized State mortgages. Bank mortgage terms were unaffordable, with interest rates around 16–18 per cent and average terms of five years.<sup>72</sup> One MFI provider issues mortgages of 5,000–200,000 AZN for three to five years. Interest rates are around 22–24 per cent, while LTV is up to 70 per cent. At this stage of development in the mortgage market, mortgages are affordable only for a small share of high-income households. Less than 2 per cent of

workers can afford monthly payments for a typical commercial mortgage; these are mainly employed in the financial sector and mining. A number of other financial institutions also offer mortgage loans, but for smaller amounts.<sup>73</sup> The microfinance sector has the potential to offer housing microfinance loans, but is focused mainly on trade and agriculture lending in regions (especially in rural areas). MFIs' social mission is to assist low and moderate-income households to get access to credit.

One of the major problems that Azerbaijan banks face with issuing mortgages and expanding their mortgage portfolios is the lack of cheap long-term capital. The short-term deposit based banks constantly operate without an appropriate match in the maturity of assets and liabilities, which further leads to high interest rates and liquidity risks. Another problem is the lack of personnel experienced in mortgage lending, necessary to implement sound risk management policies, methods and tools. It is encouraging to note that AMF and IFC have launched educational and training programmes and are actively involved in preparing industry standards and best practices. However, most banks still do not actively use insurance as a tool to mitigate mortgage risk. The insurance sector is undercapitalized<sup>74</sup> and lacks necessary links to the developing residential mortgage industry (standardized insurance policy documentation related to residential mortgages is lacking). Insurance companies working with banks engaged in mortgage lending offer mainly two insurance products: life and property insurance, which are not obligatory by law. Moreover, some of the products necessary for supporting the developing mortgage industry do not exist, such as title insurance and primary mortgage insurance (i.e. insurance against bank losses on defaulted mortgages).

The National Bank of the Azerbaijan Republic launched a centralized credit bureau on 1 January, 2005, with technical assistance from the World Bank. According to the Law on Credit Bureau,

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<sup>69</sup> Data provided by State Register Service of Real Estate of the Republic of Azerbaijan in May 2009.

<sup>70</sup> Central Asia Housing Finance Gap Analysis. IFC, 2006, p. 20.

<sup>71</sup> Data from 2007 Annual Report of the National Bank of the Republic of Azerbaijan and meetings with its staff in May 2009.

<sup>72</sup> Central Asia Housing Finance Gap Analysis. IFC, 2006, p. 26.

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<sup>73</sup> TBC Kredit offers mortgages from USD 10,000 to USD 200,000 for purchasing or construction of home or purchasing a land plot. Mortgages are provided for 2–12 years with the maximum LTV of up to 70 per cent.

<sup>74</sup> As of October, 2008, the aggregate reserves of insurance companies were about 90 million AZN.

banks are obliged to submit information on all loans electronically. During the past few years, the number of records and requests submitted to the credit bureaux increased substantially, but it does not yet have full coverage or error-free data<sup>75</sup>. Amendments to the Law, allowing for the creation of private credit bureaux, are under discussion at the National Bank.

In 2002, the Government abolished the licensing requirement for real estate appraisals, so currently anyone can start such businesses. No uniform qualification or industry standards exist, so the quality of appraisal services varies. Moreover, appraisers' financial responsibility for mistakes or discrepancies in the valuation reports is very unclear, which is why AMF had to introduce internal systems of appraisal certification. IFC has created the Association of Appraisals. It currently provides training, proposes amendments to legislation and facilitates the development of this self-regulated body.

Although realtors are quite active in the housing market, banks do not cooperate with them in promoting mortgages. The main reason is the lack of confidence in realtors because of the absence of licensing requirements. However, some realtors have offered clients mortgage advisory services at the clients' expense. Currently, there are no specialized mortgage services or collectors.

Although the mortgage segment of the financial market is expanding rapidly, a number of legal concerns limit further development. A crucial problem is that the bankruptcy laws in Azerbaijan have not been tested to any great extent, and foreclosures may take up to several years in practice, especially when court decisions are involved. This arises from the ability of the borrower-in-default to exercise the option of having the bank's claim adjudicated in court at any time, even when an out-of-court settlement is near completion. The main issues of concern were carefully identified in an IFC study in 2006.<sup>76</sup>

At the moment, two key tax elements in the development of mortgage lending are missing: (a) mortgage interest deductibility; and (b) the tax

treatment of capital gains related to the sale of residential properties. Despite these obstacles, the mortgage market has good potential for growth, but it is limited by a lack of affordable financing. The main source for mortgage operations is funding provided by international organizations such as IFC, which provides financing for several commercial banks and their housing programmes. The country's capital markets are not well developed. The total capitalization of Azerbaijani companies traded on local stock exchanges is about 3.5 billion AZN, or less than 10 per cent of the country's GDP. There is no large institutional investor, while the menu of available financial instruments is very short and lacks corporate debt securities (currently less than 75 million AZN).

Outstanding government securities (170 million AZN) are short-term (with a maximum of two years).<sup>77</sup> However, it is not certain whether there is sufficient liquidity or interest among potential bond purchasers for large issues with longer maturity periods, non-governmental pension funds still do not exist. Assets of the State Oil Fund are about USD 11 billion (and have to be invested outside of the country), but there does exist a demand for instruments with positive yield and that are affordable for households.

There is no law on mortgage securities, and hence no special tax treatment of mortgage securities or mortgage transfers. AMF has just started discussions with the Central Bank on how to stimulate refinancing operations in the mortgage industry. Despite these obstacles, during the summer of 2009, AMF issued mortgage securities (covered bonds) of some 55 million AZN.<sup>78</sup>

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<sup>75</sup> Interview with AMF staff, May 2009.

<sup>76</sup> Central Asia Housing Finance Gap Analysis. IFC, 2006, p. 33

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<sup>77</sup> *Statistical Bulletin of the National Bank of the Republic of Azerbaijan*, 3/2009, tables 3.3 and 3.4.

<sup>78</sup> Butler, Stephen, and Simon Walley. Creating a Covered Bond Framework. Report prepared for IFC, May 2008.