PRE-SALE OF FLATS AS A METHOD TO LIMIT MARKET RISK

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Abstract

The focus of this study is on the analysis of the developer's and purchaser's risks that result
from pre-sale of flats in the real estate market. This study attempts to analyze developer's and purchaser's risks that result from pre-sale of flats in the real estate market. The study discusses the results concerning the economic indices that stimulate behaviors of participants and analysis of the Developer's Act in the aspect of benefits and risk for market participants. The provisions of the new Developer's Act that introduce regulations beneficial for both customers and developers (thus improving their safety) were also discussed. The Developers Act emphasizes the importance of pre-sale as a limitation of market risk that results from finding customers at the stage of pre-sale, guarantee to sell investments at the pre-defined prices and finding funds for financing developer's projects. The analysis of benefits for both purchasers and developers that result from pre-sale of flats secured with escrow accounts points directly to reduced market and financial risks incurred by developers and lower purchaser's risk of losing their resources. It was also stressed that, however, the costs of all the legal and financial solutions increase the financial load for the customers.

Keywords: *developer, pre-sale of flats, developer's risk, escrow account.*

1. Introduction

A dynamic decline in the size of flat construction sector in the beginning of the process of transformation has revealed a number of barriers of structural character in the real estate market. Diagram 1 presents the dynamics of changes in flat construction sector with a number of flats built in Poland in 1992-2008.

As we can see from the analysis of the data presented in Diagram 1, the process of transformation was started in Poland with a relatively low level of construction. The number of flats built was declining in consecutive years,

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reaching a minimum level (slightly over 62,000) in 1996. Since that moment, a gradual increase was observed until reaching the threshold of 115,000 in 2006 (Kirejczyk, 2009).

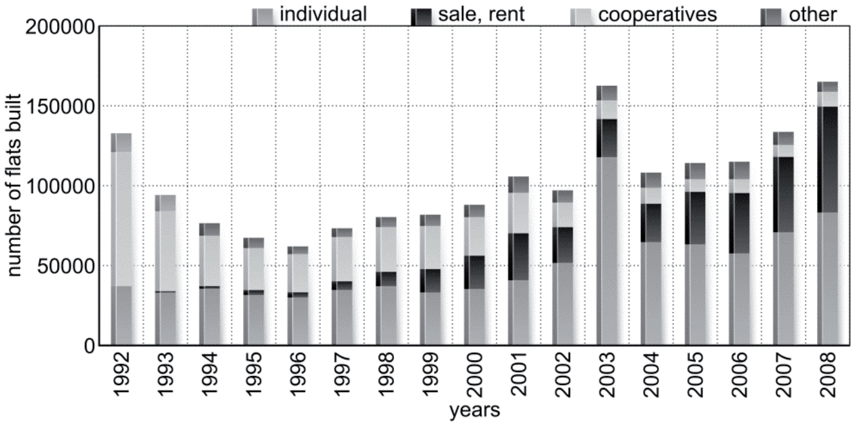

Figure 1. Structure of flats built in Poland in 1992-2008 with respect to investor's category

Source: Kirejczyk (2009, p.4)

Low income of people, connected with even lower level of economic growth, represented the basic barrier in market development, pointing to the necessity of subsidizing the real estate sector.

An average monthly salary in Poland is sufficient for only 0.8 square meters of a flat. An even worse situation is observed in the biggest cities, where the average salary allows for buying only 0.5 to 0.6 square meters.[1] In the Western European countries, the average salary of a citizen is sufficient to buy ca. 2 to 3 square meters of a flat. In Poland, the purchase of an average-size flat necessitates spending 6 to 8 yearly salaries, whereas in better developed countries, these needs can be covered using only 2.5 to 3.5 years' salaries (Łaszek et al., 2013; Łaszek, 2004) .

Low incomes of society and high costs of building/prices of new flats cause that only part of society is able to satisfy their housing needs directly in the market. The factor that substantially increases financial ability of households with medium incomes in the housing sector is long-term financing, which usually adopts a form of mortgage loans. Availability of loans, especially mortgage loans, has increased substantially in the past two decades through

1 „Główne problemy, cele i kierunki programu wspierania rozwoju budownictwa mieszkaniowego do 2020 roku" – author: Council of Ministers, print No. 3725, status: March 4, 2011, adopted through voting and directed to the Commission of the Infrastructure

competition and gradual economic stabilization. However, it remains lower than in highly developed countries.

For a long time, banks avoided financing of housing construction sector, whereas developers shifted the high risk of building flats on consumers and compensated it with high gratuities, which resulted in increasing the prices. Consequently, the purchaser's situation was unfavorable since, while competing for flats, they accepted unfavorable terms of contracts proposed by the developers. Due to the fundamental problem of risk in the real estate market, the integral part of investments in this segment, suggestion of actions aimed at achievement of greater transparency of activities of financial institutions in order to stabilize the system and its effective operation inspired the analysis of the research problem presented in this study.

The focus of the study is on analysis of developer's and purchaser's risks that result from pre-sale of flats in the real estate market.

The analyses used the data from the Real Estate Market Database (BaRN), National Reports on Mortgage Loans and Transactional Prices of Real Estate AMRON-SARFIN Polish Banks Association and analysis and reports of the Financial Supervision Commission (KNF), published collective credit data from Credit Information Bureau (BIK) and the Central Statistical Office of Poland (GUS) and documents containing sector-related data.

2. Risk of developer's activity

Any activity based on the banking sector as the greatest segment in the financing system is exposed to risk. Also in Poland, especially in the real estate sector, the investment activity is exposed to a substantial risk, particularly in the period after the crisis in 2008-2010. Since flat aspirations of the Polish society remain unsatisfied (being still estimated in Poland at 1,500,000 flats; Raport Polska, 2011) while the main participant in the real estate market are developers, it is necessary due to very risky investments in this sector to implement measures to minimize the risk either through risk segmentation, compensation (self-insurance and insurance), division and repressive methods. With regard to the risk specific to the real estate market as connected with the properties of real estate, there are methods of its observation, evaluation and opportunities for risk manipulation and consequently, substantial minimization. Furthermore, the systematic risk that results from economic risk depending on economic policy, inflation and evaluation of the economy by the foreign capital is not reduced by the real estate market but the whole economy.

A particularly important kind of risk for developers is market risk (Bechciński, 2008). Any entrepreneur operates under variable market environment, but long period of implementation of developer's investments causes that their activity is particularly exposed to the variability of situations in the market. Pre-sale helps to reduce market risk connected with the decline in the demand for flats as well as connected with the decline in prices which might occur during realization of investments until the moment of a flat transfer.

The risk of changing the economic situation affects, in a direct manner, formation of the level of selling prices and relationship between the supply and demand for flats. Rapid changes in prices of building materials, difficulties with finding qualified workforce (2007) that resulted in prices of costs of labor, noticeable increase in supply that manifested with a high number of flats built presently and planned to be released in the next year and competition are other determinants of developer's risk.

Despite improved economic tendencies, a particularly sensitive area of risk is the risk related to financing investments by banks and other financial institutions (Bryx, 2001). The pre-sale helped developers collect the resources which were presented in the bank as their own contribution, which allowed them to present good credit standing or reduced costs of credits. If a developer demonstrated to a bank that part of flats were sold through a pre-sale, the financial risk of this project was regarded as lower since banks evaluated this situation as a sufficient demand for particular flats in the area.

It should be emphasized that developer's activity is characterized by high exposure to risk factors, both due to its capital-intensity and long term of the investment process, necessity of involvement and coordination of work with many market participants and insignificant flexibility of the final product which declined with the progress of works. However, the pre-sale is limited by both market and financial risks of housing investments.

3. Selected economic indices that stimulate behavior of real estate market participants

Proper assessment of the phenomena that occur in the market remains a key task for making market decisions by investors. Reliable information about changes that occur in the market will allow for limitation of the risk of a specific investment to the minimum level. The basic criterion for evaluation of the status of individual markets are indices used for improving market transparency. It can be improved as a result of collecting and sharing market information, whose usefulness consists, among other things, in limitation of the risk of improper evaluation of the real estate, which translates directly on investment effectiveness.

Economic indices, such as unemployment rate, GDP increase rate, inflation and levels of interest rates translate directly into behavior of the real estate market participants, with particular focus on the purchasing power of potential customers. Diagrams 2, 3, 4 and 5 present basic economic indices that affect behavior of the real estate market participants.

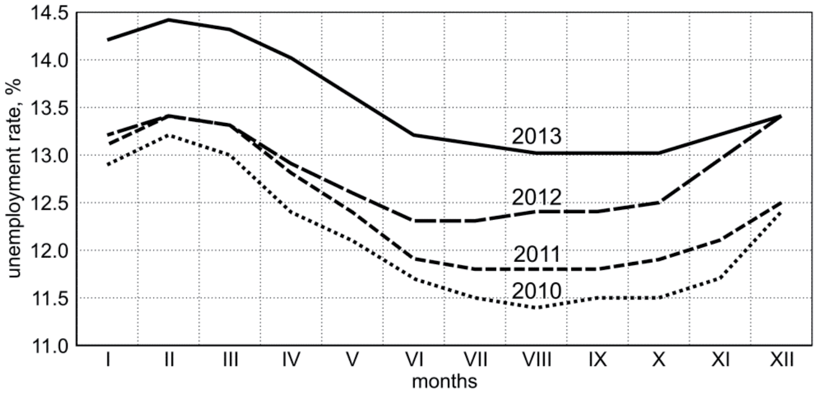

Figure 2. Unemployment rate in Poland

Source: GUS, IBnGR (2014, p. 2)

The data presented in Diagram 2 demonstrate that the unemployment rate at the end of the year 2013 was 13.4 %. However, the analysis of the data reveals its changes compared to the end of 2012 and increase by 0.4% compared to the end of the third quarter.

Furthermore, the increase in unemployment rate in previous years at the end of the fourth quarters compared to the situation from the third quarters was greater. This reflects the gradually improving situation in the labor market.

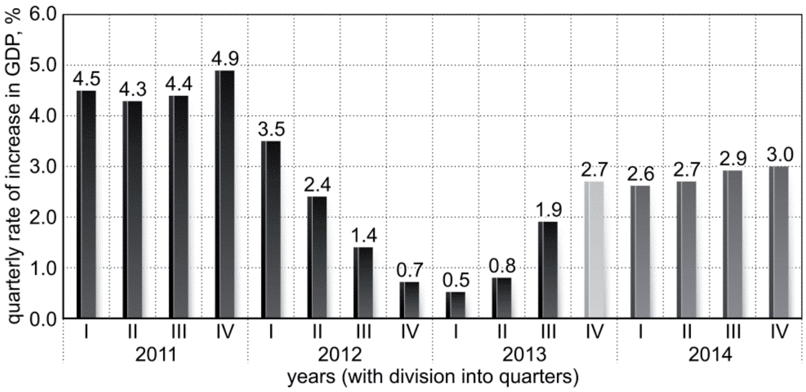

Figure 3. Quarterly rate of increase in GDP

Source: GUS, IBnGR (2014, p. 3)

Diagram 3 shows that mean rate of increase in gross national product in 2014 will reach 2.8% in 2014, which means that it will be substantially higher than in 2013, with the rate of GDB increase being 1.48%. It is remarkable that the economic growth will accelerate in consecutive quarters of 2014, but the differences between quarters will be insignificant: in the first quarter, the GDP will increase by 2.6%, while in the fourth quarter, this value will increase by 3.0%. According to the forecast of IBnGR, further acceleration in the economic growth at the level of 3.5% is expected in 2015.

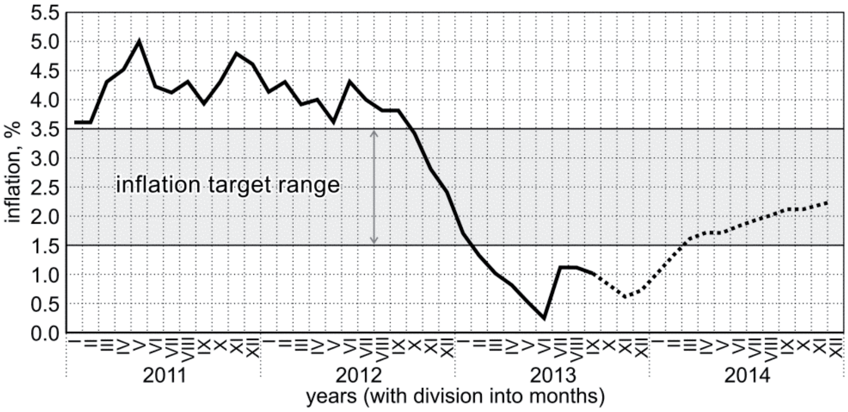

Figure 4. Inflation in Poland
Source: GUS, IBnGR (2014, p. 4)

Diagram 4 and forecast of IBnGR show that inflation will reach 1.9% on average in 2014 and 2.2% at the end of December. In 2015, inflation will remain actually at the 2014 level, with mean level forecast at 2.0% and the level for the end of December at 2.1%. Relatively low inflation will be one of the factors to positively contribute to the dynamics of individual consumption. (Inflation below the inflation target of the National Bank of Poland means that changes in interest rates in the central bank should not be expected).

In the whole 2013, sales reached the level of 36,000 flats i.e. they increased by 17.5% YOY and were similar to the record number from 2007 (according to the National Bank of Poland, ca. 74% of total sales of flat resources built are performed by developers).

Furthermore, low interest rates (diagram 5) were conducive to the tendencies of withdrawing resources from deposits and converting them into investments in relatively cheap real estate. From the viewpoint of credit customers, the beginning of 2013 was characterized by an accumulated demand for flats in the fourth quarter of 2012 connected with completion of the Program Rodzina na Swoim (Family with their Own Flat). On the other hand, also in the fourth quarter of 2013, the amendment of the Recommendation S and introduction, from 2014, of the requirement of the 5% own contribution stimulated demand and increased the interest in loans with 100% LTV.

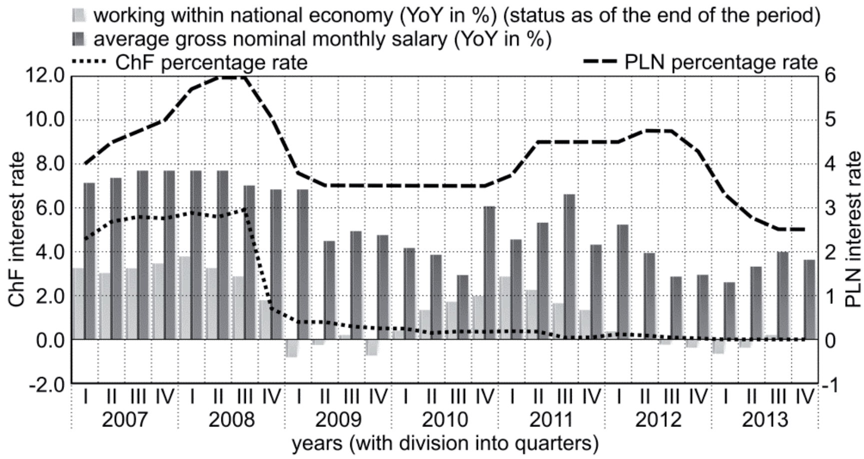

Figure 5. Dynamics of employment and average salary in national economy on YOY basis and interest rates

Source: NBP Macroeconomic Analysis (2014, p. 10)

The dynamics presented and the analysis of selected economic indices that stimulate behavior of participants of the real estate market show that improvement in economic tendencies in general in 2013 and, first and foremost, the lack of changes in the unemployment rate compared to the end of 2012 (Diagram 2), forecast rate of GDP increase in 2014 (Diagram 3), low inflation below the inflation goal of the GDP (Diagram 4) and low percentage rates (Diagram 5) at relatively low prices of flats, generated in 2013 a strong demand impulse. The demand growing from quarter to quarter, reaching 10,900 flats (according to REAS) in the last (fourth) quarter of 2013, is comparable with the sales observed in the boom peak i.e. in the beginning of 2007.

4. Developers Act: benefits and risk for real estate market participants. Pre-sale

Specific conditions of operation of Polish housing market (previous lack of legal regulations for developer's activity, limited financing of developers by banks, imbalance between supply and demand in the primary market) have led to the situation where financing the growth of the primary real estate market in Poland is based mainly on the loans granted by individual customers. Loans for developers' projects represent an insignificant part of the market of real estate financing and cause that the risk of failure of developer's projects is incurred mainly by the future purchasers of the flats who finance the building with their payments at the account of the developer (Jajuga, 2007). This model of operation of the housing market does not ensure steady development and sufficient securing of the rights of flat purchasers.

On September 1, 2011, Polish Parliament passed the Act on protecting the rights of purchasers of flats and houses which is supposed to protect customers of developer companies from losing the money in the case of bankruptcy of the developer which are not the developer's current assets. Since April 29, 2012, the act of September 16, 2011 started to be enforced concerning the protection of rights of purchasers of flats or detached houses (Journal of Laws No. 232, 2011). The new act is expected to prevent from malpractices connected with concluding and realization of developer's contracts and protect the rights of purchasers in case of developer's bankruptcy.

With respect to the investments implemented with so-called developer's system, i.e. from the resources paid by the customers, the money paid will not become the current assets of the developer but they will be redirected to one of the three types of escrow accounts. The resources from the escrow account will be paid to the developer after completion of the investment (in the case of closed escrow account) or after completion of a stage of the investment (in the case of open escrow account or open escrow account with insurance or banking guarantee). It can be expected that the most frequently used solution will be open escrow account[2]. In this case, the payment of the part of resources occurs after completion of a specific stage in advancement of construction works (adequately to its level) after controlling it by the bank. With closed account, the payment of the resources deposited occurs once, but only after transfer of rights to flats or houses on purchasers i.e. at the stage that ended the whole investment. Additional guaranty is supposed to protect the purchasers in case of a company's bankruptcy. This solutions is most likely to be commonly used. Furthermore, in the event of developer's bankruptcy, only the people that concluded the preliminary agreement in the form of the notarial deed will be best protected since presence of the solicitor improves the safety of transactions, but preparation of the preliminary agreement in the form of the notarial deed means additional costs for purchasers.

Changes implemented by the Developers Act with respect to the previous status are presented in Table 1.

2 Minimum payment for starting an open escrow account in Bank PKO BP (according to the information provided in the bank's website www.pkobp.pl) was PLN 4,500 as of January 1, 2012 whereas the cost of closed escrow account was PLN 3,600.

Despite implementation of particular legal regulations, new developer's act raises much controversy and reservations e.g. with respect to escrow account i.e. opportunities for using alternative forms of protecting the purchasers of flats or through banking escrow account, providing almost unlimited control of the developer's sector by the banking sector.

Table 1. Comparison of the previous status and changes implemented with new act on protecting the rights of purchasers of developer's flats

No.	Previous status	Changes after April 29
1.	Preliminary agreement is not obligatory to be signed in the form of the notarial deed	Preliminary agreement must be signed in the form of the notarial deed and claims of purchasers should be considered within the mortgage register
2.	Lack of protection of the purchasers in the case of bankruptcy of developer, making them "stand in a long queue" to get the money back after liquidation of the bankruptcy	Payments of customers for the real estate built are excluded from the bankruptcy estate and can be also guaranteed by the insurer and banks
3.	Escrow account is not obligatory	Escrow account is obligatory
4.	Conditions of resolving the contract between developers and purchasers are determined individually	Conditions of concluding the contract between developer and purchaser are contained in the act
5.	Developer provides information about the company and investment with limited scope	Developer is obliged to prepare a comprehensive information brochure about the investment, previous achievements and financial standing

Source: Turek (2012)

It is banks that decide who should be assigned the escrow account and whether it should be open or closed. Furthermore, in the case of an open escrow account, banks are obliged to transfer resources to the developer's account. However, this is possible after previous inspection of the documentation and completion of a particular stage in realization of the initiative. For prudential reasons, banks are allowed to request making several independent inspections of the state of realization of a particular initiative (obviously, at the expense of the developer).

Home Broker and Polish Developer Association conducted a survey among the companies that built anonymous flats concerning the hierarchy of problems and barriers the developers have to face in their activity (Siwek, Turek/Home Broker, 2012). The survey concerned the macroeconomic situation, administrative barriers and market conditions. The evaluation was conducted on a scale of 1 to 5 (1 – the question does not represent a problem, 5 – the question represents a big problem).

The results of the survey show that 3 groups of problems are dominant:

- present macroeconomic conditions:
  - unstable economic conditions: 3.93 indications (78% of the respondents),
  - danger of decline in prices of real estate: 3.76 indication (75% of the respondents),
- administration barriers and risk of decline in prices of flats:
  - administrative procedures of obtaining the building permission (including development conditions if there are no Local Plan of Spatial Development): 3.85 indications (77% of the respondents),
  - frequent changes in administrative procedures connected with construction process: 3.56 indications (71% of the respondents),
  - frequent changes of fiscal regulations: 3.27 indications (65% of the respondents),
  - risk of a decline in the prices of flats: 3.75 indications (74% of the respondents),
- market conditions:
  - achievement of the required level of pre-sale of the project before payment of the first tranche: 3.27 indications (65% of the respondents). However, according to developers pre-sale represents a barrier for financing of developer's activity since reaching the required level of pre-sale of project before payment of the first tranche of banking financing received the average score at the level of 3.27 points. According to the new act, developers, before obtaining the funds from financial institutions, are obliged to conclude preliminary agreements to sell from 10% to 30% of flats. This high assessment of this aspect of business activity demonstrates that the requirements imposed by banks are often difficult to meet by developers. Therefore, as many as 53% of the enterprises that built flats did not use banking financing. The funds are obtained in these cases from the own capital or e.g. payments of customers,
  - finding an attractive land: 3.20 indications (64% of the respondents),
  - obtaining financing for a project: 3.17 indications (63% of the respondents).

As results from the analysis of the results of the survey:

- macroeconomic situation represents the main threat to the developer's sector. It is manifested in particular by a reduction in the demand due to the reduced number of the mortgage loans granted, which represents a serious problem for the whole construction sector,
- on the second position, developers mentioned administrative barriers which still represent a serious threat that inhibits investments,

- insignificantly fewer problems are caused by market conditions, especially obtaining financing of developer's projects. The problem becomes very important at the moment of implementation of the developer's act that limits the access to these loans.

In light of regulation of the mechanisms, National Real Estate Market (2011) aimed at improving credibility of the primary housing market and its organization and amended Recommendation S that concerns good practices in terms of granting mortgage loans, minimum own contribution in the case of applying for a mortgage loan amounts to 5% of the purchased flat or a house from beginning of the year 2014. According to the recommendations of the Financial Supervision Commission, the minimal own contribution in 2015 will be 10%, followed by 15% in 2016 (or 10% after purchasing an additional policy) to reach the target value of 20% (or 10% for insured loans) in 2017.

With this respect and particularly according to a new Developers Act, it becomes very important to protect the purchasers of the flat or house from losing the money paid in the case of the developer's bankruptcy in order for them not to become the developer's current assets. The pre-sale of flats before starting construction investments or in the middle of this investments causes, according to the new developer's agreement, that:

- the purchaser has better choice of flats and houses sold within a single investment,
- the purchaser of the real estate has an opportunity to withdraw from the contract in the case of developer's being unable to ensure updating or changing information in the information brochure of the developer's company,
- benefits to the purchaser of the real estate being built include stability of the price, which, in light of the results of the survey, represents a serious problem for developers since, on the one hand, developers are protected from the fall of prices and, on the other hand, they incur the risk of the increase of costs during realization of the investment. However, depending on the content of the developer's agreement, the final price can be sometimes higher than the primary price,
- while concluding a higher number of developer's agreements, developer increases the number of flats sold within the pre-sale if a particular project in the real estate market is sold within the escrow account,
- through pre-sale, the developer:
  - earns greater financial revenues,
  - is able to repay the loan more efficiently,
  - is exposed to much lower risk that the investment will not be sold at the assumed prices, producing the expected income.

In order to counteract the effect of another threat i.e. the market risk of competition, developers offer interesting gratuities to prevent a decline in the rate of sales and correction of prices of flats. Instead of reducing prices for flats, developers guarantee free finishing of the interior, goods vouchers, radical reduction in prices of parking places or they offer attractive schedule of payments.

Therefore, pre-sale of real estate performed through developers' agreement as a legal instrument is beneficial for both developer and purchaser of the real estate. However, it has also a small drawback compared to the pre-sale of other goods: long period between concluding the agreement and obtaining the goods ordered.

In general, pre-sale generates high risk if it does not result from the new Developers Act (Thornhill, 1993). This is connected with not obtaining the goods the purchaser paid for i.e. the real estate. The determinant of this risk is time since the longer the time between a pre-sale and transition of the real estate, the higher the risk of unexpected events (financial problems of the developer leading to delays or bankruptcy, problems with subcontractors, with administration and other participants in the real estate market).

The risk for purchaser is eliminated in light of the new Developers Act by the escrow account which ensures that pre-sale is safe.

Therefore, it should be emphasized that, considering the benefits for purchaser and developer that result from the pre-sale of flats within the escrow account, pre-sale limits the market and financial risk of the developer while it reduces the risk of losing the resources of the purchaser paid within the pre-sale.

5. Conclusion

The analysis of risk of developer's activity in the context of selected economic indices that stimulate behavior of participants in the real estate market and legal regulations implemented with the new Developers Act demonstrated the requirement of pre-sale of housing resources built before the payment of the first tranche of banking financing at the level of 10% to 30% of flats.

Pre-sale of flats offers benefits to both purchasers and developers. For developers, the pre-sale limits the market risk and financial risk of a particular investment. In light of the new act, pre-sale also increases the safety of the purchaser, especially in case of the developer's bankruptcy.

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