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Abstract

International experience suggests that there is a strong causal link between housing demand, housing finance, financial sector development and economic growth. Yet, a housing market cannot flourish without mortgage finance, which allows all but the poorer segments of the population to purchase, expand or improve their homes, or to use the equity in their homes for other purposes, such as major purchases, college education, travel or investment. There is now growing recognition of these connections among policy-makers in developing and transition countries, and among international development donors who wish both to strengthen financial markets and to improve the economic well-being of citizens in their client countries. This paper provides an overview of the constraints and opportunities for condominium housing and mortgage lending in emerging markets.

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I. Introduction: The Link between Housing and the Overall Economy

The link between a vibrant housing market and the overall health of a nation's economy is well-established in developed countries—construction and manufacturing jobs, wholesale and retail sales, population mobility and other factors are directly affected. In many countries, housing data are used as an economic indicator that changes before the economy starts to follow a particular pattern or trend, and predicts the health of a country's overall economy. In the United States, for example, a leading economic indicator is the *New Residential Construction Report*,¹ known as "housing starts" on Wall Street, a monthly report issued by the U.S. Census Bureau jointly with the U.S. Department of Housing and Urban Development (HUD). A downward trend in housing data was an early harbinger of the current economic upheaval in the United States.

On the other hand, a well functioning housing market can provide large external benefits to the overall economy, including the following:

- Better overall living conditions for families who can access and improve their shelter.
- Improved urban infrastructure, since housing demand stimulates utilities, schools, transportation and the like.
- Enhanced economic and social mobility within urban markets and regionally.
- Improved labor market mobility, diversity and accessibility.
- Increased motivation to save.
- Increased consumer spending.

Carol S. Rabenhorst is Senior Legal Advisor in the International Activities Center at the Urban Institute in Washington, DC. The Urban Institute has over 15 years experience with condominium housing in developing countries, beginning with the privatization of state-owned rental apartments in the early 1990s, and has played a leadership role in projects that prepared Condominium Laws, created condominiums as a legal regime of home ownership, established associations of owners in condominiums and helped owners access financing for renovation of their properties. Sonia Ignatova is a former Research Associate at the Urban Institute and a graduate of the Georgetown University Law Center.

¹ See <http://www.census.gov/const/www/newresconstindex.html>. The data are derived from surveys of homebuilders nationwide, and three metrics are provided: housing starts, building permits and housing completions. A housing start is defined as beginning the foundation of the home itself. Building permits are counted when they are granted.



- Increased spending and investment by homeowners who borrow against the value of their homes.
- More capital for entrepreneurs who borrow against the value of their homes.

International experience suggests that there is a strong causal link between housing demand, housing finance, financial sector development and economic growth. Through urbanization, the development process generates sharp increases in mobility and relocation, and housing investment increases as a share of GDP.² A housing market cannot flourish without mortgage finance, which allows all but the poorer segments of the population to purchase, expand or improve their homes, or to use the equity in their homes for other purposes, such as major purchases, college education, travel or investment. There is now growing recognition of these connections among policy-makers in developing countries, and among international development donors who wish both to strengthen financial markets and to improve the economic well-being of citizens in their client countries.³

II. Condominium Housing Markets in Developing Countries

In developing countries, mortgage markets start first in the largest cities, usually the capital city, where the commercial banking sector takes root, where there are enough potential borrowers to launch mortgage lending on a cost-effective scale and where housing units usually have the highest value. Condominium housing often represents a substantial portion of the potential market for mortgage lending in large cities; in many countries it is the largest segment of the market. Across Central and Eastern Europe (CEE) and the former Soviet Union, large-scale privatization of state-provided and owned apartment buildings in the early 1990s resulted in mass owner-occupied housing markets.⁴ The new owners acquired ownership in the form known throughout the world as *condominium*—individual ownership of a unit and an interest in the common property (the entrance, stairways, roof, etc.). In addition to the hundreds of thousands of formerly state-owned apartments that have been privatized, construction of new apartments in more recent years has added to the stock of condominiums in these countries. There are now 9 countries from the former Soviet bloc that are members of the European Union⁵; in most of them owner occupancy rates reach 90 percent or above, and at least 75 percent of the urban populations live in owner-occupied apartments (Schweinichen 2006).

Other developing countries that have not undergone mass privatization programs also have growing condominium housing markets concentrated in the new construction sector rather than resulting from apartment privatization. In large cities in South Africa, Kenya,

² Framing the Issues: Housing Finance, Economic Development, and Policy Innovation, Joint Center for Housing Studies of Harvard University, May 2005.

³ See, for example, Gwinner (2007).

⁴ In the majority of cases, ownership was transferred to the sitting tenants, generally with a legally mandated right to purchase under extremely favorable terms (e.g., below market price, small down payment, minimal or no interest rate, etc.)

⁵ Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.



Tanzania, and in Thailand, Indonesia and India, many buyers with middle class and higher incomes regard condominium housing as highly desirable, especially in buildings with a high level of security and other services. Purchasers are the rising middle class, and sometimes members of the African or Asian Diaspora who have substantial funds earned in other countries and who wish to invest in and visit their homeland but are not able to reside there fulltime. Most new construction of condominiums must be financed by the purchasers themselves since there is little or no institutional finance available for multi-family housing development.⁶

Privatized condominiums in Eastern Europe and the former Soviet Union are often in extremely poor condition because low construction standards and years of deferred maintenance under the socialist regimes. The renewal, management and maintenance of multi-family residential buildings is regarded as one of the most critical problems in the region.⁷ While the interior of the individual apartments were often kept in good condition by the residents, the common areas were usually grossly neglected. The owners have equity (that is, some “capital” that they can use as collateral) in their own apartments that could be used to secure financing for the renovation of their current home—either through individual loans for their own apartment or jointly with other members of the owners’ association for common area repairs or upgrading. Individual owners could also use their equity for the purchase of a larger or more desirable apartment or single-family home. Therefore, mortgage loans secured by condominiums should in principle be an important segment of mortgage lenders’ portfolios, and contribute substantially to the financial health of the housing sector, financial markets, the economic well-being of citizens and to a country’s economy of as a whole.

III. Constraints on Financing for Condominium Development and Purchase

Why then are we not seeing more robust development of new financing products, particularly for the development and purchase of units in condominiums in newly constructed buildings, and for renovation and repurchase in older buildings?

Three principal constraints account for the difficulty of making loans secured by apartments and for hampering the growth of developing mortgage markets. These are:

1. Inadequate, or non-existent, laws and procedures for registering title and other ownership interests in condominium housing;
2. Lack of experience among lenders with financing the development of condominium housing; and
3. Poor management of common areas of condominiums and inability to enforce the obligations of individual apartment owners.

⁶ See Rabenhorst et al., Concept Paper: Mortgage Finance Legal Reform in Moldova, for EBRD, December 2006.

⁷ United Nation Economic Commission for Europe, Achievements and Challenges, 2006-2007.



This paper discusses these three issues in turn—the constraints they pose and how they can be remedied, as means to expand the link between condominium housing and mortgage markets in developing countries. It offers a comparative analysis of the emerging mortgage markets in several countries and the developed mortgage sector in two countries—the United States and Australia, with focus on the role of the condominium sector in development of mortgage markets.

Issue 1: Registration Laws and Procedures

When property offered as collateral to secure a loan is not properly defined and registered in the land registry, it is impossible for the lender to register a mortgage on the property. In a condominium, the apartment and the share of common property appurtenant to the apartment should be registered as a separately identified parcel of real estate, and the mortgage should be registered against that. Procedures for such registration should be included either in a Condominium Law or the Law on Real Property Registration.

Land and buildings attached to land account for between half and three quarters of the wealth of most countries (Ibbotson, Siegal, and Love 1985), making secure property rights a key element of market-based economies, sustainable economic development, poverty reduction and good governance. Wealth represented by land cannot be effectively realized without effective registration systems. “Good land registration promotes an active land market and productive land use. It makes possible the security of tenure and the development of a mortgage market on which a functioning economy depends.”⁸

In many developing countries and emerging markets, a large proportion of property is not registered, and the registry systems that exist do not afford adequate security. However, the last several decades have seen an enormous increase in property values and, partly as a result, a strong impetus for sound registration systems.⁹ International donors have invested large sums in improving registration systems in large scale projects that often take from five to 10 years or more. However, in many transition countries, even those where property registration has undergone substantial reform, condominium housing is still not properly registered—making tenure insecure and the property less attractive to mortgage lenders.¹⁰

In the registration of condominiums, the respective components of the ownership—individual ownership of the apartment unit and co-ownership of the common parts of the building—must be clearly denoted in the land registry, including the percentage or share of ownership of the common property appurtenant to each apartment. This allows

⁸ *Guidelines on Real Property Units and Identifiers*, UN Economic Commission for Europe, 2004.

⁹ In some countries registration itself has increased the value of property significantly. In Thailand, for example, since land registration and tenure reform began in the 1980s, titled land has become between 75-197 percent more valuable than comparable non-titled land (Burns 2005).

¹⁰ In Croatia, for example, virtually all of the former state-owned rental apartments have been privatized, but 90 percent of them are not properly registered in the deed registry, despite the fact that the World Bank loaned 25 million USD to Croatia in 2002 for improvements in the cadastre and land registration system.



ownership and other rights, including contract rights, to be established and made enforceable, since some of the most important rights and obligations of the individual owners are measured by the percentage or share of the ownership interest in the common property. The amount of each owner's respective fee to maintain the common property, for example, is usually determined by the size of the individually owned property—the apartment—in relation to the other apartments, i.e., the owner of the largest apartment pays the most to maintain the common property, owners of apartments that are equal in size pay equal amounts, and so on.

The condominium registration system in the United States is itself only 50 years old. The first condominium legislation in the U.S. or its territories was the Puerto Rico Act of 1958.¹¹ Three years later, the Federal Housing Association (FHA) enacted Section 234 of the National Housing Act of 1961 based upon the Puerto Rico model,¹² and also drafted a model statute—the FHA Model Condominium Act (1962)—in order to provide guidelines for the states in adopting their own condominium laws and at the same time ensure that they comply with the requirements of § 234.¹³ The typical statutory scheme establishes a legal structure for the condominium development based on three organizational documents: (1) declaration or master deed; (2) bylaws; and (3) unit deed. The declaration or master deed is required for creation and registration of the condominium, and is also the document by which the condominium is established as a legal entity.¹⁴ The information that a declaration must contain includes the name of the association for the condominium, the name of the condominium itself, the name of every county or district in which the condominium is situated, the largest number of units that the declarant reserves the right to build, etc.¹⁵ The declaration also contains information on the allocation of common elements interests, votes, and common expense liabilities.¹⁶ The unit deed is the instrument by which the interest in each unit, along with an appurtenant interest in the common areas, is conveyed to each unit owner. The bylaws contain information on how the condominium is to be governed—usually through a legal entity called an owners' association, and sections on election of officers and their responsibilities, election of members of the board of directors and their responsibilities, meeting and voting procedures, rules regarding payment of fees for regular and special assessments, and the like. The unit deeds are similar to any deed for individually owned property, but also contain a reference to the condominium common property and the share appurtenant to the unit.

Condominium laws in transition countries in CEE, especially those with EU membership such as Hungary, Slovakia and Romania, generally follow the U.S. model with regard to allocation and registration of interests. Many countries, however, particularly in Africa

¹¹ P.R. LAWS ANN. Tit. 31, § 1291-1293(k)(Supp. 1968)

¹² 12 U.S.C.A. § 1715 (1988). This statute, or one of its descendants, was adopted in every American state.

¹³ Most state enabling statutes followed this model initially, with some variations, as the drafters of the model statute had envisioned. *See* 1 and 2 Ferrer & Stecher, *Law of Condominiums* (1967) (providing the verbatim text and comparative analysis of the FHA Model Condominium Act and the state statutes.)

¹⁴ Uniform Condominium Act (1980), § 2.101 (“A condominium may be created pursuant to this Act only by recording a declaration executed in the same manner as a deed.”)

¹⁵ Uniform Condominium Act (1980), § 2.105

¹⁶ Uniform Condominium Act (1980), § 2.107



and Asia, have inadequate condominium laws and property registration; some have no condominium law at all. Kenya and Moldova are examples. Under their laws, it may not be clear how the common property is allocated among the owners of apartments, and what the responsibilities for maintenance and operating expenses are. In those places, registration records may not be correct and title to condominium property is often not considered adequately secure for mortgage lending purposes.

Issue 2: Financing the Development of Condominiums

Demand for housing in newly developed apartment buildings is very high, but mortgage lenders are constrained from tapping into this market. In many places, the usual way to finance the construction of apartment buildings is for the apartment buyers to pay a substantial portion (sometimes all) of the sales price to the developer before the building is built. The mortgage system is bypassed, and the owner takes the risk that the apartment will never be built or not built to the expected standard. In addition to providing for the establishment of condominiums as a form of real estate, a Condominium Law also should regulate the activities of developers, by providing for the shift from developer to owner control of the building, warranties against construction defects and preparation by the developer of proper legal documentation for registration of the property and the owners' association

In countries with developed housing markets, there is a tested scheme for financing multi-family, owner-occupied housing. Construction loans are available to the developer, on commercial loan terms, coupled with “take-out” loans to purchasers of apartments on mortgage loan terms. The individual mortgage loans may be used to reduce the developer’s obligation on the construction loan as the apartments are purchased, or may simply be paid to the developer.¹⁷

In the U.S., for example, many buildings are financed by two different loans before and after completion of the project. During the construction phase, a construction lender provides the money that the developer needs to finance the actual construction in the form of a construction loan. This is a short-term loan that gets paid in full upon completion of the building(s). At that point, the financing for the project is provided by a long-term loan—the permanent financing. In order to ensure the existence of permanent financing and minimize their own risks, construction lenders require that a developer seek and obtain a takeout commitment from the lender who will provide the long-term financing for the project before they release the construction loan. The takeout commitment, usually in the form of a letter, guarantees to the construction lender that at the time of completion of construction, there will be another lender to take over the long-term financing of the project. It does not, however, remove all other risks associated with

¹⁷ The Uniform Condominium Act permits each of these allocations to be made on different bases and to be unrelated to value. The bylaws of the condominium association set forth matters related to the operations of the association and the internal management of the condominium. They provide for the number of members of the executive board, the election of various board members, their qualifications, powers, and duties, which of the officers may prepare, execute, certify, and record amendments to the declaration on the behalf of the association, and the method of amending the bylaws.



construction loans that construction lenders must bear in mind. On the other hand, the long-term lender, by making a loan for a building that has already been constructed, need not be concerned that the developer might abandon the project prior to completion.

One important protection for construction lenders is the requirement that a developer invest a substantial amount—at least 5 percent, more often 15 to 20 percent—of its own funds in the project in order to reduce the risk to the construction lender if the developer fails to complete the building. Virtually no commercial lender today would fund 100 percent of a development; in fact, regulations may require that the maximum loan-to-value ratio be limited to a certain percentage.¹⁸ In addition, the loan is advanced to the developer in several payments, each following the satisfactory completion of a phase in the construction as stipulated in the construction loan agreement. Further protection for the lender from default, which can include anything from shoddy work to abandonment of the project as well as nonpayment, is provided by the purchase of a performance bond by the contractor, which guarantees that the contractor will satisfactorily complete its obligations under the construction contract. The bond may also be used in the event that estimates exceed the actual costs of completion of the project.

These requirements and conditions for making a construction loan, while applicable to condominium financing, are not unique to condominium projects and apply to construction financing in general.¹⁹ However, due to the specific risks²⁰ associated with the condominium type of ownership, condominium construction loan documentation may receive more scrutiny than other construction loans. Special areas of concern include: (1) the underwriting analysis; (2) compliance with state and federal regulation; (3) presale and resale requirements; (4) condominium document review; (5) availability of permanent financing (multiple unit end loans); and (6) assignment of developer rights.

How does a scheme like the one in the U.S. develop and how long does it take? The condominium enjoys wide acceptance among American home buyers today and perhaps this is why we tend to forget that condominium as a form of home ownership are of quite recent origin. An account of the history of the development of the U.S. condominium market reveals that some of the issues that arose in the United States as the market was developing are the same one faced by market participants in countries with developing mortgage markets today.

¹⁸ In the U.S., there is almost no secondary market for construction mortgage loans. Fannie Mae piloted a construction loan pilot program where the mortgage on the ultimate units would be under the conforming loan limit, but suspended the program in 2006 after concerns about the security of the secondary market instruments were raised by Fannie Mae's regulator, the Office of Federal Housing Enterprise (OFHEO), after an OFHEO safety and soundness audit. Freddie Mac has been even less involved in the housing production market, due to charter restrictions that limit Freddie Mac to dealing only with loans associated with a completed residence.

¹⁹ Many apartment buildings in the United States are built for the rental market, which includes all income levels, as well as for owner occupancy. The same loan structure could apply to rental buildings, with a mortgage on the entire property used to secure the permanent financing.

²⁰ Because owners of individual units share the common parts of buildings—such as common entrances, elevators, and stairs, - the value of the individual units depends both on the maintenance of the units *and* the maintenance and upkeep of the common areas. The maintenance of the common parts and the good management of the entire building is thus crucial in condominium-type developments.

In the 1960s and 1970s, lenders in the United States had significant concerns as to whether this new type of ownership known as condominium would gain market acceptance among buyers. Construction loans for the financing of condominium development came with an attached pre-sale condition, which required the developer to have pre-sold a certain percentage (typically 60 to 70 percent) of residential units in a condominium project to qualify for a construction loan (Kane 1999).²¹ Because the demand for condominiums at the time was high, developers were easily able to sell units in buildings that were yet to be built and to meet the lenders' pre-sale requirement. Lenders, previously overly cautious, became overly confident when they saw the large profits from the sales of condominiums and started making construction loans that financed virtually 100 percent of the developers' cost of acquiring the land, constructing pre-sale models to show to prospective buyers and the common areas of the projects. But when the oil embargo by the Organization of Petroleum Exporting Countries (OPEC) triggered dramatic increases in the cost of construction materials in the mid-1970s, and developers found themselves unable to complete their projects for anywhere near the initially contemplated cost, many of them walked away from the unfinished condominium projects. Since almost all the financing had come from construction loans, rather than developers' own money, the lenders were left to bear the financial burden and to foreclose on a large number of unfinished projects. This episode repeated itself once more in the mid-1980s when borrowers had once again been able to negotiate loans on a fully exculpated basis²² in the context of a booming real estate market and lenders once again had to foreclose on the projects when the market collapsed in the late 1980s. The lenders ended up with condominium units that were worth far less than the amount of the loan and the owners of units in unfinished condominium projects found themselves having prepaid for units that would never be built (at least not at the initial cost). And both had no recourse against the developers and no claim for the developers' assets other than the unfinished condominiums.

The current problems in the U.S. mortgage market have affected the security of construction loans for condominiums as well as individual mortgage loans, with commercial banks and real estate investment funds bearing the losses. The percentage of condominium construction loans that are in default have been steadily increasing from 2.6 at the end of 2006 to 10.1 at the end of 2008.²³ Increases are attributable to slow sales and broken sales contracts, as the value of condominium property decreases. It remains to be seen whether lenders will learn from this history and avoid the no-recourse and no equity lending allowed in the past.

²¹It is also generally true today in many countries with developing mortgage sectors that developers have to pre-sell the units in a condominium project before construction has even begun yet in order to secure financing for the project.

²² In the event of default, the lenders' only recourse would have been to foreclose on the security, with no right to pursue any of the borrowers' other assets.

²³ The rates were 4.2 percent at mid-2007 and 6.0 percent at the end of the third quarter 2007. Foresight Analytics, Oakland, CA, February 2008.



Issue 3: Management of Common Areas and Enforcement of the Obligations of Individual Owners

In the aftermath of privatization in CEE, large numbers of new owners were required by law to assume management responsibility for their buildings but did not have the financial, legal or technical tools to fulfill their obligations. Today, condominium owners in transition countries continue to face problems such as unclear delineation of their rights and responsibilities, lack of meaningful choices in contracting for management and maintenance services and inadequate financial resources to make needed repairs to their apartment building. This is also the case in other emerging markets in Asia and Africa. Without a well-drafted Condominium Law, there is no system for managing the common areas of the apartment building and for enforcing rules and obligations imposed on the apartment owners.

Clear condominium rules and obligations are important in the mortgage context. Inadequate maintenance and management practices result in diminution in value of apartments, which makes it difficult to underwrite a long-term loan for an apartment and increases the lender's risk of loss of value of the collateral. If there is no owners' association constituted as a legal entity, buildings in poor condition cannot obtain mortgage financing to renovate, since an association is necessary to organize the individual owners and enforce their obligations to pay debts. Minimum quality standards for mortgage lending should require establishment of a condominium owners' association, and evidence of an appropriate governance and rules enforcement structure. The Condominium Law should set out the fundamental rights and obligations of ownership, with specific rules relating to the operation of a particular building adopted by the owners in the form of bylaws.

Australia is often looked to as a model legal regime for condominiums, particularly by Asian countries such as Singapore, Indonesia, Malaysia, the Philippines and Fiji. The current legislation in Australia, the Strata Schemes (Freehold Development) Act 1973, was enacted to resolve the most common problems in condominium-type developments—the rights and responsibilities of unit owners, the management of common areas and the resolution of disputes. The 1973 Act repealed earlier enabling legislation, the Conveyances (Strata Titles) Act of 1961, and contained new provisions to deal with the problems. It introduced more stringent by-laws defining the obligations of individual owners, detailed the functions of the “body corporate” (the owners' association) and required the developer to conduct a meeting with the body corporate within a month of selling one-third of the units in a building. This avoids leaving the development without effective management at any given point in time, and provides a system to expedite the resolution of disputes (see Christudason 1996, 348).

In the 1960s and 1970s, in Singapore, a strong economy led to an increased pace of construction, particularly condominium-type developments, spurred by local demand as well as by demand from foreigners. Before the introduction of legislation, there was no way to regulate the behavior of owners of individual units in a subdivided building, no platform for the informal adjudication of disputes, and resort to the courts was expensive

and slow. Singapore passed a Land Titles (Strata) Act in 2001, basing registration of condominiums on the Torrens system similar to that used in Australia, and a Building Maintenance and Strata Management Act in 2004 (Christudason 1996).

How detailed should the rules on condominium management and governance be? Cultural norms often dictate what is and what is not included in condominium bylaws and in house rules. House Rules, which relate to operation of the building and relationships among owners, need not be registered with the other documents and tend to be easier to adopt and amend than bylaws. Two rules of a condominium association in Singapore are particularly interesting and reflect the values of that particular community/culture: “(g) when upon the common property to be adequately clothed;” and “(l) ensure that the part of the floor is sufficiently covered where chillies are being bounded to prevent transmission of noise likely to disturb the peaceful enjoyment of another subsidiary proprietor or occupier” (Christudason 1996, 360). In the U.S., it is said that condominiums house rules often relate to The Three P’s—parking, pools and pets. Examples include what kinds of vehicles can be kept in the parking garage, supervision of children at the swimming pool, whether pets are permitted and if so their maximum weight.

In the United States, the rights and obligations of unit owners with regard property management are generally stipulated in bylaws passed by the owners by majority rule. In Singapore, the by-laws are set forth in Schedule 1 to the Act (Christudason 1996). While rules in one building may seem irrational to residents of another, the point is that good management and governance—and maintenance of property values—require clear and reasonable rules and the means to enforce them.

IV. Conclusion

Condominium markets are expanding all over the world, especially in large cities, as more people see owner-occupied apartment housing as an attractive alternative to single-family housing—more affordable, secure, easily serviced by urban infrastructure, energy and resource friendly. As mortgage markets continue to develop apace, lenders will find ways to solve the problems of financing construction and purchase of apartments, as long as laws on property registration and operation of condominiums are carefully drafted and enforced. This will require collaboration between the private sector and government legislators and policy makers. With good example provided by the U.S. and Australia, already adopted in some of the more advanced markets in Europe and Asia, the future looks bright for condominium housing mortgage lending.



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