THE RELATIONS BETWEEN A DEVELOPER AND HIS CLIENTS – REMARKS ABOUT THE POLISH INSTITUTIONAL FRAMEWORK

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1. Introduction

Residential supply has an impact on a living standard of citizens, the rise of a new generation but also the national economy by influencing employment and generating revenues. The supply side depends on the structure and the level of development of the construction industry. The financial and organizational structure of this industry varies among countries due to differences in: potential economy of scale, market factors, information asymmetries, regulations and risks. The special role is played by a developer - in developed real estate markets recognized as one of the basic actors of the supply side of the market.

Relations between a developer and his clients (consumers) and creditors depend on legal rules, formal and informal norms, networks, business culture. This environment evolves together with market cycles, technological and cultural evolution. The socio-political and the economic transformation experienced by the post-socialist states concerned the basic elements of the institutional framework, and new legal rules and amended acts established a new order for the future, however, the consequences of the past are still existent and are responsible for creating a unique environment. The aim of the article is to investigate factors influencing the relationship between a developer and his clients (consumers) on the Polish residential market.

2. The developer - a new actor on the market

There are various definitions of a developer and his activity, pointing out different factors due to an enormous scope of a developer’s operations on the residential and commercial markets. In well developed economies developers mostly specialize in chosen submarkets, like offices, residential or retail space. There are some further subdivisions, typically, land developers and developers responsible for the whole process of the residential supply creation operate on the residential market. Some researchers suggest that in the competitive market differences in risks and returns between land development and residential construction are responsible for a tendency to separate these activities.

During the socialist time, giant state construction companies and producers of materials supplied the residential building sector in Poland. House-building was never a priority sector and the supply was insufficient in terms of the quantity and quality of dwellings. Small private firms tried to fill the gap, especially in the single-family housing. The transformation from the centrally planned economy to the market economy has revealed many problems, eventually a part of the giant companies had to split to increase profitability of their businesses; some private developers, who worked in the socialist time on a small scale, started to operate on a larger scale and compete on the residential market.

At the beginning of the transformation process, weak knowledge about financial planning was a significant barrier, most of

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3. M. Ball, Markets...op. cit., p.167.
the development companies had no relevant experience in the market-oriented economy. The organizational structure was weak, it was difficult to foresee all the costs and timing of the investment in the changing legal and economic environment. Developers were often vulnerable, thinly capitalized, and sometimes relatively unprofessional in conducting their construction activities or other critical aspects of the project management (notably legal, administrative, financial, and commercial). These factors effectively discouraged banks from financing development projects.

In theory, developers could use different forms of construction finance: developer equity, buyer deposits (including presales), developer finance to buyers (installment sales), construction loans provided by financial intermediaries to developers, and bond markets through the securitization of construction loans. However, in the Polish reality developers were interested mostly in clients’ money as they did not have enough equity to realize their projects and banks were reluctant to give them loans (they lent money mostly to the biggest and most prestigious developers, often connected to the banking sector). That was the reason why the pre-payment system appeared and embedded. The institutional framework was not prepared for the new situation, clients (consumers’) money had no adequate institutional protection.

3. Risks of a developer

There are many complex risks related to every phase of development projects, notably related to the pre-construction and construction phases and the commercialization process. A developer needs to calculate each project individually due to the unique locational characteristics so there is no truly standard product of a developer’s activity. He estimates the probable cost, revenue and profits knowing different sources of risk. The risk arises from:

- construction issues (costs and time of completion),
- general housing market conditions,
- financial sources,
- regulatory barriers (building regulations, spatial planning rules),
- the price paid for the land together with a fee and the obligations required by the local government,
- the level of meeting the demand expressed by households.

A developer needs and uses many pieces of information about the economic, social, political, environmental situation in his area of activity to identify the types of risks related to his project, to measure their intensity. It is necessary for the efficient management of risk. However, the position of a developer in comparison with his clients and financing source representatives gives him some benefits emerging from asymmetry of information. A developer being highly geared financially could feel encouraged to take a far larger risk than a creditor evaluates he is taking.

Comparing the environment of a developer’s operation in the traditional market-oriented economies and in Poland, the developer has to deal with:

- economic and political risk,
- competition risk,
- interest rate risk,
- exchange rate risk,
- risk of non-availability of attractive land,
- risk of extra works, delays caused by contractors,
- risk of local spatial plans,
- risk of real estate legal defects,
- risk of the lack of buyers due to the incorrect evaluation of clients’ preferences,
- risk of an increase in operating costs,
- risk of non-availability of the sources of funding,
- risk associated with the lack of effectiveness of the land registry,
- risk associated with the need to establish escrow accounts,
- risk associated with the embezzlement and the disloyalty of employees,
- risk associated with the use of abusive clauses,
- risk of failure due to the lack of experience, etc.

The number of risk sources is much bigger on the Polish market. The lack of management experience, the lack of appropriate skills, the desire to get rich in the fastest way contributed to the fact that some developers had economic problems, and sometimes went bankrupt. Their situation was worsened by a long period of the implementation of projects, often due to administrative and legal problems. These factors, together with the lack of business culture and ethics, created a very difficult environment for developers’ clients, gaps in the institutional framework caused the lack of protection for the clients’ money.

4. A relation between a developer and his clients (consumers)

In Poland, during the transformation, new legal rules and amended acts established a new order, however the revolutionary changes left some gaps in the institutional framework. There has been the lack of a long term and consistent housing policy

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6 M. Ball, Markets..., op. cit., p.162.


8 This asymmetry increases the level of transaction costs, a special type of practices related to the use of advantages in the access to information are: adverse selection and moral hazard.


10 These types of risk were indicated by developers listed on the Warsaw Stock Exchange in their prospectuses, e.g.: BBI Development, J.W.Construction, RONSON, Plaza Centers, etc.
and, as a result, some changes have been introduced without proper preparation and their effects have been not in line with the assumptions.

The positions of the groups of interest on the market depend on their strength. Analysing the relationship between developers and their clients, it is necessary to indicate their interest, requests and wishes. In fact, this kind of relation involves more actors than just the two mentioned group - there are also banks and other financial intermediaries who have an important voice in activating projects, and the state as an actor responsible for the general institutional environment. Developers want to gain the highest profits, any additional costs, responsibilities are not welcomed; clients who are consumers, not professionals, need protection, particularly in the conditions of asymmetry of information. Financial institutions want to minimize the risk of loss and also collect profits. The state conducts its own policy - the level of market intervention should reflect this policy realized in the form of legal regulations and special institutions.

The group of developers was able to influence the legal regulation, the bargaining power was strong enough to block attempts to enhance the protection of clients for some years. Their main point was that the existing law was sufficiently rich to protect clients. However, in reality, clients (consumers)' money was not protected enough. Ultimately, after some years of debates, the Office of Competition and Consumer Protection established a special collection of imposed clauses in developer contracts and gave an opportunity to counteract. The Ombudsman also called for an improvement in the legal position of the developers' clients.

The protection was needed due to the fact that clients had no experience, knowledge or information that would allow to assess projects. They were not aware of many legal traps and so inexperienced that they bought even "a hole in ground" as a developer's project. They had problems with understanding the consequences of the signed contract. Particularly, in case of bankruptcy of a developer financed by pre-sale, the position of the client who took a mortgage credit and had only a written form of the contract was very weak.

In Western Europe, many years of the free market-oriented economy allowed to establish some rules that protect developers' clients. Modern consumer protection law there splits into two competing concepts - the first one considers the consumer as rational and able to make decisions and choices in their own interest and the other one indicating that some negative contract outcomes, especially if related to the most vulnerable in the society, matter for the society as a whole. The first approach emphasizes the adequacy of information and anti-discrimination, the other one gives the right to intervene even when the information is provided, transparency exists and contracts are negotiated fairly.

The Polish debate about the protection of developers' clients reflects these approaches in a distorted mirror. After some years of denying the need for enhancing the protection of developers' clients, even from the point of view of the first approach of the consumer protection law (there was a problem with the basic information, transparency, etc.), a new act is introduced which seems to interfere too much in the market conditions. This act can cause unwanted effects for developers' clients.

The most needed changes refer to a formal side of the contract and special account for pre-payment (obligatory). Additionally, a developer has an obligation to publish a detailed prospectus for the investment, which becomes a part of a development contract. Any changes must be clearly formulated and accepted by the buyer. What is essential for the protection of buyers' interests is changes in bankruptcy law: payments made to special accounts, as well as the ownership of a real property are not included in the equity of the developer. They form a separate equity, which aims at meeting clients' requests. The future of property and debts are dependent on the decisions of an assembly of buyers.

5. Conclusions

In Poland, a rapid transformation of the institutional environment resulted in the failure of the specific regulation of development activities, but also in the lack of fair play among developers and the ignorance of the rules governing the economy and the housing market presented by buyers.

The assessment of the legal situation left no doubt about the legitimacy of enhancing protection rules, particularly in terms of the precise form and the rights and obligations of both parties of a development contract. Clients should be provided with the availability of necessary data to evaluate the project. In case of bankruptcy, there should be a way to get back money or the dwelling.

However, in the Polish conditions, the belief that external factors, such as legislation, should protect a client so strongly that he has no obligation to think about his own financial security creates a moral hazard. There is a general question how far the state should interfere in market relations between a developer and his client. Unconsidered and reckless filling the gaps of the institutional framework may lead to unwelcome results. A very favorable position of the developer in comparison with the position of clients (customers) should be changed, there is no doubt. However, the sudden expansion of the essential duties of developers, combined with tighter credit conditions may result in a drastic reduction in supply in the medium and long term. An unclear regulation will not protect clients in the way they expected. Clients should take care of their own interests. Some of important decisions will be shaped only by them - clients need to know and understand their effects, e.g. in case when

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11 Raport z kontrol w zarzeczym w utilisowanych stosowanych w umowach deweloperskich 2007.


13 L. Chiquier, M. Lee [ed.], Housing ..., op.cit.
they, together, decide about money and the project’s future in case of bankruptcy of the developer.

When evaluating the direction of changes, it should be mentioned that the change of legal regulations is easy but an implementation of new institutions in reality needs a change in people’s minds – in both parties: developers and clients. The new regulation will not take off the responsibility from clients. They still should collect and analyse information before taking a decision. In the Polish conditions, there is a threat of moral hazard due to a very low level of knowledge about economy and the lack of clients’ willingness to take care of their own money.

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The Relations Between a Developer and his Clients – Remarks about the Polish Institutional Framework

(Summary)

After a long battle for a higher level of protection of developers’ clients, this year the Law on the Protection of a Purchaser of a Dwelling against a Developer has been introduced. An assessment of the previous legal situation left no doubt about the legitimacy of enhancing the protection rules, however, reckless filling the gaps of the institutional framework in the form of an unclear regulation may lead to unwanted results. There is a general question how far the state should interfere in the market relations between a developer and his clients. The authors emphasize that a client has also an obligation to think about their own financial security and no legal regulation will take off this responsibility.

Relacje między deweloperem a jego klientami – uwagi dotyczące polskiego otoczenia instytucjonalnego

(Streszczenie)

Po długich staraniach dotyczących lepszego zabezpieczenia klientów deweloperów, w tym roku uchwalona została Ustawa o ochronie praw nabywcy lokalu mieszkalnego lub domu jednorodzinnego. Ocena wcześniejszej sytuacji prawnej, nie pozostawiała wątpliwości co do zasadności zwiększenia poziomu ochrony klientów, jednakże nierozważne uzupełnianie luk w instytucjonalnej ochronie poprzez wprowadzanie niejasnych regulacji, może prowadzić do niepożądanych rezultatów. Zasadniczym pytaniem pozostaje kwestia, jak dalece państwo powinno ingerować w rynkowe relacje pomiędzy deweloperem i jego klientami. Autorzy zwracają uwagę, iż klient dewelopera jest także zobowiązany do dbania o własne bezpieczeństwo finansowe i żadne regulacje prawne nie zdejmą z niego tej odpowiedzialności.