NATIONAL BANK OF SLOVAKIA

CEE HOUSING LOAN RECOVERY COLLOQUIUM PROCEEDINGS AND MAXIMIZING HOUSING LOAN RECOVERY LESSONS FOR CENTRAL AND EASTERN EUROPE

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Bratislava 1996

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AND MAXIMIZING HOUSING LOAN RECOVERY
LESSONS FOR CENTRAL AND EASTERN EUROPE**

**East European Regional Housing Sector Assistance Project
Project 180-0034
U.S. Agency for International Development**

**THE URBAN INSTITUTE
2100 M Street, NW
Washington, DC 20037**

November 1996

Mortage Banking - New Type of Banking Activity in the Slovak Republic

Introduction

The ambition of this paper is to provide elementary information about the implementation of mortgage banking under the conditions existing in the Slovak Republic. The need for reintroducing this type of banking activity must be seen from two perspectives. The first is, that within the development of Slovakia's banking system, this means extending demand by new, specific banking products (mortgage loans), naturally linked with special capital market products (mortgage-backed bonds). The second is the solution to chronically persisting problems with the generation of temporarily available long-term resources in the economy, whereby mortgage products are expected to contribute significantly to the change in the proportion of loans in favor of long-term financing, and to the revival of investments.

One of the banking products that combines the two aspects of banking transactions, active and passive transactions, is a mortgage loan, financed, or refinanced by issues of mortgage-backed bonds. Unlike classic mortgage loans, this mortgage model has an advantage in the method of accumulating long-term financing resources. However, the effectiveness of this model is conditioned by the existence of potential investors willing to invest their available long-term financial resources in safe, high-quality, and high liquidity securities. Securing the sales of extensive issues of these securities in the future will not only depend on the level of stimulation and the establishment of rules for secure investing by the existing institutional investors, but also on instituting new entities on the financial market -- pension funds. Although the Pension Insurance Act was approved this year, accumulation of larger volume of resources may only be anticipated in the coming years (1-2 years).

The reverse side of the coin is the ability of banks to meet the demand for mortgage loans at a price that is relatively low from the perspective of loan applicants, and sufficiently attractive for potential investors in comparison with other investment opportunities (state, corporate, or other bank bonds). A bank will establish the price (interest rate) of mortgage loans with regard to the price of resources it acquires, the interest rate development on the market, and potential risks linked with mortgage transactions, interconnected with the overall level and heading of the economy in Slovakia. It is evident that the introduction of mortgage loans and mortgage-backed bonds to the financial market will not resolve the problem of financing construction investments, particularly to satisfy the need for housing on a massive scale, as is often maintained in public. Some alternatives for making mortgage products cheaper exist if the state decides support this sphere of activity: by decreasing the income tax base, providing interest subsidies to mortgage loan issuers, exempting mortgage-backed bond yield from income tax, by establishing a specialized institution which would be buying mortgages from banks, thus proving resources for new mortgage loans, or by formulating an effective system of guarantees and insurance.

Characteristics of Mortgage Products

Forming of a legal framework, harmonizing legal norms directly or indirectly linked with the introduction of mortgage banking, and clearly defining "rules of the game" are an essential preconditions for an effective development of this sphere of banking activity. The amendment to the Act on Banks, as well as amendments to other legal norms (Securities Act, Bankruptcy and Settlement Act, and the Civil Court Order) have constituted a solid groundwork for launching mortgage transactions.[1]

The adopted model is known as the so-called "rigorous block system", which is essentially based on constantly providing for a prescribed equilibrium between the volume (sum) of mortgage-backed bonds in circulation and the volume of receivables from mortgage loans secured by collateralized real estate. For an investor, not only information about issues of mortgage-backed bonds and the quality of mortgage portfolio and its coverage is important, but also about the quality of real estate marketability. Despite relative safety, this system is highly demanding with regard to management of assets and liabilities -- the time aspect, the need to stabilize long-term loan resources, mortgage-backed bond issues with a fixed maturity set in advance; the tendency towards imbalance between mortgage loans and mortgage-backed bonds is dealt with by so-called proper and substitute coverage (see table 1 -- Basic characteristics of mortgage loans and mortgage-backed bonds in the Slovak Republic). A further condition for healthy mortgage transactions is the relation between the interest rates on mortgage-backed bonds and mortgage loans, as well as determining the necessary minimum interest rate margin. The application of these essential rules will require further specification of these principles (such as, should the interest rate margin include reserves for classified loans, the relationship of mortgage transactions and generally applicable rules of the banking business).

The current situation

Only those banking entities that receive a corresponding license may conduct mortgage transactions. The minimum volume of required financial deposit is 1 billion Sk (or an equivalent sum in foreign exchange). What are the advantages or the relatively high requirement of basic property?

* it limits the range of potential applicants for mortgage financing, which corresponds with the principle of the implemented model of mortgage banking. At this stage, it is neither desirable, nor safe and effective to grant a license to all, or a large number of banking entities;
* mortgage transactions will be carried out by entities with strong capital backing, which decreases the risk of reduced liquidity of the new product;
* safety of mortgage-backed bonds, ensuing from capital strength of the issuer, is a precondition for the willingness to invest in mortgage-backed bonds;
* it eliminates potential risks, including legislative ones, and their impact on the issuers of mortgage-backed bonds;
* the risk of entry of these banking entities which do not meet the criterion of capital adequacy and have uncovered losses is partly compensated by higher basic capital.

An application for a license must contain general conditions for providing mortgage (municipal) loans, the method of keeping the mortgage register, the method of keeping separated analytical documentation in the accounting system, a nomination of a person to the post of administrator, and his/her deputy, and a system of real estate appraisal[2].

[1] The Slovak Republic is the second among the countries with transforming economies (after the Czech Republic) to have instituted the essential rules for the application of the mortgage block system (see tab. 2)

[2] We assume that in the initial period, with regard to the level and economic position of the banking sector, three or four banks will receive a license.

Table 1

The basic characteristics of mortgage loans and mortgage-backed bonds

mortgage loan	mortgage-backed bond
mortgage loan is:	mortgage-backed bond:
- a long-term loan with maturity of at least five years	- a special publicly tradeable security
- genuinely guaranteed by collateral right to domestic real estate	- its name is protected by law, this security must be labelled "mortgage-backed security"
- specifically designated for acquiring, construction, and maintenance of domestic real estate	- nominal value, including yield, is covered by receivables from mortgage loans
- financed (refinanced) through the issue and sale of mortgage-backed bonds	- resources acquired from the sale of mortgage-backed bonds are designated for (re)financing mortgage loans
- mortgage loans (re)financed in the aforementioned way may only be provided by banks, which acquire a corresponding license	- only banks that get a license to carry out mortgage transactions are authorized to issue mortgage-backed bonds
- a safety level quotient, coverage of a mortgage loan by real estate is set by law at 0.6 (the ratio of the loan to the value (price) of real estate is 60 percent)	- the coverage principle -- so-called proper coverage -- for the cover the issued mortgage-backed bonds, only receivables from mortgage loans not exceeding 60 percent of the value of the collateralized real estate may be used; the so-called substitute coverage is limited to 10 percent of the value of issued mortgage-backed bonds, only by precisely specified assets (deposits in the NBS, treasury bills, deposits in banks, cash, state bonds, state treasury bills, mortgage-backed bonds, municipal bonds issued by other banks)
- the value of real estate is appraised by a licensed bank on the basis of an overall evaluation of the real estate	- a bank may issue temporary mortgage-backed bonds within six months after the license to carry out mortgage transactions becomes effective, on the basis of a decision of a general meeting, up to the volume of 50 percent of the bank's basic capital, whereby within one year from issue, the bank is obliged to replace them by mortgage-backed bonds defined above
- a mortgage loan cannot be guaranteed by real estate on which collateral right to the benefit of a third person has been established or exists; the transfer right to real estate must also not be restricted	
- a bank carrying out mortgage transactions may temporarily deposit free resources acquired from these transactions in a bank (a branch office of a foreign bank) in Slovakia, use the money to purchase mortgage-backed bonds, communal bonds issued by another bank, treasury bills of the National Bank of Slovakia, or state bonds	
- the bank must keep a list and volume of mortgage loans that serve as coverage for mortgage-backed bonds in its mortgage register	

- With consent of the Finance Ministry and at the proposal of the bank, the NBS appoints a mortgage administrator, whose role will be to oversee mortgage transactions	

In the viewpoint of completing the process of forming the so-called minimum legal requirements for preparing and launching mortgage transactions, it is essential to complete the phase of formulating the binding directives on the provisions for the mortgage register, and technicalities regarding the position and activities of the mortgage administrator and his/her deputy. The purpose of the mortgage register is keeping a unified and simple system for the registration of mortgage loans (volume, maturity, interest rate, real estate collateral characteristics from a cadastre transcript; price of the collateral -- the corresponding real estate, established by various methods, for calculating the volume of the mortgage loan), which would serve to cover mortgage-backed bonds. The aim of enhancing supervision over mortgage transactions (specific supervision) by introducing the "institute" of mortgage administrator (his/her deputy) is to limit risks on both sides of mortgage transactions. The determining momentum is real estate appraisal, from which the safety and quality of mortgage loans and mortgage-backed bonds evolves, the size of the bank's basic capital (or the bank's own capital) as the source for coverage of potential risks, a thorough analysis and management of risks, as well as meeting the obligations towards owners of mortgage-backed bonds (bank's creditors).

The protection of mortgage-backed bond owners is dealt with in the Bankruptcy and Settlement Act (an additional safety enhancement of this bond) -- if the bank defaults, claims of owners must be settled preferentially. Amendments to the Civil Court Order create room for the protection of a bank should a mortgage debtor fail to meet his/her obligations. When collateral right is enforced, the collateral right of the bank is satisfied before that of other collateral creditors.

The most critical point however is only a limited possibility to enforce collateral right (too strong protection of non-paying tenants -- the necessity to provide appropriate alternative housing, protracted court procedures, and enforcement of claims, etc.). For this reason, a conservative behavior of banks in the mortgage loan domain may be anticipated when providing mortgage loans, at least until a corresponding amendment is adopted to the Civil Code.

Municipal transactions (municipal bonds, municipal loans) have the same legal basis, whereby the purpose of their use differs, and is defined as follows: banks provide these loans for purchases, construction, and maintenance of domestic real estate, with the aim to use them for public benefit. A bank acquires resources for financing (refinancing) of municipal loans by issues and sale of municipal bonds. Municipal bonds issued by banks have the following features: they are publicly tradeable securities, they are properly covered by receivables of the bank from municipal bonds (these are secured by collateral right to real estate of the debtor -- a municipality), or alternatively covered (appropriate provisions concerning mortgage-backed bonds apply here).

From what was stated above ensues that 1997 and 1998 will be a period of verification of the essential aspects of mortgage financing (both economic and legal), and at the same time, a period of direct identification of imperfections (mistakes), and their gradual rectification.

A comparison of fundamental legislative norms in mortgage financing

	Czech Republic	Poland	Slovak Republic
1. Essential legislative norms	- Act No. 530/1990 Collection of Laws on Securities, in the wording of subsequent directives Act No. 513/1991, Collection of Laws, Commercial Code, in the wording of subsequent directives - Act 328/1991 Collection of Laws, on Bankruptcy and Settlement, in the wording of subsequent directives - Act No. 21/1992, Collection of Laws, on banks, in the wording of subsequent directives	- draft bill on mortgage notes and mortgage banking	- Act No. 21/1992, Collection of Laws, on banks, in the wording of subsequent directives - Act 328/1991 Collection of Laws, on Bankruptcy and Settlement, in the wording of subsequent directives - Act No. 530/1990 Collection of Laws on Securities, in the wording of subsequent directives Act No. 513/1991, Collection of Laws, Commercial Code, in the wording of subsequent directives
2. Basic Capital	500.0 million CZK	The volume of basic capital will be set by the president of the Polish central bank	1.0 billion SKK
3. Mortgage loan to value ratio	70 percent	60 percent	60 percent
4. Secured right of banks to real estate	No other collateral right may exist to the real estate. An exception is that it may serve as security for a loan provided by housing construction savings bank	Not specified explicitly in the draft bill, but shall be defined in mortgage bank guidelines	A mortgage or municipal loan cannot be secured by collateral right to a real estate on which collateral right towards a third person already exists, or the transfer right of which has been restricted
5. Mortgage loan maturity	20 years	5 to 10 years	at least 5 years

6. Issue of mortgage-backed bonds	Only banks with a corresponding license may issue mortgage-backed bonds	Only banks with a corresponding license may issue mortgage-backed bonds	Only banks with a corresponding license may issue mortgage-backed bonds
7. Mortgage-backed bonds form	dematerialized	mortgage-backed bonds are issued both in document and immaterial form	dematerialized
8. State support for mortgage financing	- mortgage-backed bond yield is exempt from taxation - state support for reducing the interest rate - decreased issue fees for mortgage-backed bonds	- The Act on mortgage-backed bonds and mortgage banking counts on an exemption of mortgage-backed bond yield from taxation	Not established thus far
9. Special supervision	The finance ministry will issue a directive on supervision over mortgage-backed bond issues and related activities	Chairman of the Polish central bank appoints an administrator and his/her deputy for each mortgage bank	With consent of the Finance Ministry and at the proposal of the bank, the NBS appoints a mortgage administrator for each mortgage bank
10. Usage of free resources	Unspecified in the Securities Act	- depositing in banks assigned by a decree of the Polish central bank Chairman - purchase of securities under specified terms guaranteed by the state or the Polish central bank - purchase of own mortgage-backed bonds	- temporarily free resources from mortgage transactions may be deposited in banks with residence in the Slovak Republic, or a branch office of a foreign bank in Slovakia - may be used for purchases of mortgage-backed bonds issued by other banks or municipal bonds - NBS treasury bills purchases - state bonds purchases - state treasury bills purchases.

11. Appraisal of collateralized real estate	A mortgage bank that provides the mortgage loan will set the price real estate price as a typical price.	The finance ministry appoints entities authorized to make real estate -- collateral appraisals. The appraisal may only take into account those properties of the real estate and income related with its usage that, under normal circumstances, any owner can acquire.	The mortgage bank appraises the value of real estate on the basis of its general evaluation. The bank may take into account the permanent features of the real estate and yield it may bring over a longer term.
12. Termination of collateral right	By repayment of the mortgage loan	By repayment of the mortgage loan	By repayment of the mortgage loan