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MORTGAGES IN EUROPE

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Introduction

A mortgage loan ranks among one of the oldest bank products. There are two aspects to this type of loan that cannot be separated from one another, namely a legal and an economic one. From the legal point of view, a mortgage is defined as a pledge over real property, from the economic point of view it is a type of loan the repayment of which is secured through the establishment of a pledge on a specific real estate property in favour of a mortgagee. Involved may be a property that itself is subject to financing, or (other) properties. The mortgaged property may be owned by the mortgage loan (ML) applicant or another person, e.g. their family member. In the past century mortgage loans concerned primarily capital project financing. Such investments relate to business activities and catering for housing needs.

Over the course of history, several different methods of mortgage financing have evolved in developed economies.[1] European countries, including some economies in transition, are typified by two basic methods. Firstly, **the so-called traditional (classic)** one**,** where the essential feature is that mortgage loans are (re)financed from different types of deposits. Secondly, there is **the so-called mortgage bond (MB) model.**[2] This system is **exclusively or prevailingly** based on raising the funds needed to make mortgage loans (ML) from the issue and sale of special types of bonds – mortgage bonds (MB) in capital markets. Such bonds are typically purchased by institutions with long-term funding – institutional investors, such as insurance companies, pension funds, investment funds. Credit institutions (universal or specialised banks) and natural persons are not excluded from this activity (of purchasing) either. It is evident and has been proven by many years' experience, that prerequisites of an effective application of the MB system are the existence of an adequately

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[1] Of interest is the North-American system (the U.S.A, Canada). The secondary mortgage market has come to be highly developed in this continent. This market involves the issue and sale of mortgage instruments backed by special groups (so-called pools) of mortgage loans. This process is known as the securitization of assets - mortgage loans. The primary goal is to transfer risks and "ownership" of mortgage loans to a third party. By selling mortgage loans, deposit institutions (commercial banks, savings banks) and mortgage lenders raise funds that serve them for making new loans. Liquidity, continuity and last but not least also the security of real estate financing is strengthened in the primary market. Government, government-supported or quasi-governmental institutions in addition to ensuring the flow of funds to the primary market, have the task of providing loan insurance or guarantees. The largest players in the secondary market in the U.S.A. are Fannie Mae and Freddie Mac.

[2] A mortgage bond is deemed to be a European financial product par excellence. Its basis derives from the Greek hypothec, Italian and Dutch bonds. A MB is a fixed-yield security backed by pools of first-rate assets - mortgage loans. Over the whole maturity period, the assets in question remain on the balance sheet of issuers - universal or specialised banks responsible for their due servicing.

functioning financial market, its institutional set-up, creation of rules for secure investment and the level of incentives.

As estimated by the EC Mortgage Federation (EC MF), as many as 62% of housing mortgage loans in circulation are refinanced from personal deposits, followed by their refinancing through mortgage bonds – 19%, building society savings – 5%, other methods – 13%, and mortgage backed securities – 1%.

The study presented aims to give professionals information on selected issues related to mortgage credit in developed European countries. We have focused our attention, in our opinion, on problem areas that our banking entities with a mortgage business licence have also been encountering during the short time of conducting this business (e.g. mortgage products and risks associated therewith, the amount of additional transaction cost, incentives, early repayment, and the like.)

There is no uniform directive on mortgage credit in place in member countries of the EU. A proposal for such a directive has not yet been passed, or, more precisely, been passed on its first reading in the European Parliament.[3] Mortgage products, by contrast, i.e. a mortgage loan and a mortgage bond, are referred to in several directives, the core principles of which have more or less been transposed into national legal frameworks while, of course, retaining links to the historically formed model of mortgage financing of the particular country. The most important provisions of the respective directives give room for comparing the degree of harmonisation of Slovak mortgage products and mortgage business legislation with that of the EU.

Separate sections are devoted to the experience of Germany and Denmark, since the systems of mortgage bonds in these countries are considered as the most developed and their share in the European market for mortgage bonds is the greatest. The data on the total value of pfandbriefe bonds in circulation (more than EUR 1 billion) confirm that the German market still ranks among the largest bond markets (after the U.S.A and Japan).

The data presented in the Annexes is not supposed to give a detailed analysis of the market for real estate in developed EU countries. Rather, we have aimed to bring some facts to attention – especially the trends in the development of prices of residential property and

[3] Despite the fact that the proposed directive was not passed, it is generally considered to be "a summary of principles by which EC/EU member countries should abide when drafting mortgage legislation." See: JUDr. PhDr. M. Tomášek, CSc. : Bankovnictví jednotného vnitřního trhu Europské únie (The Banking Industry Within Single Internal Market of the EU), Linde Praha, a. s., 1997

differences in the way how the so-called housing price index is determined. For the time being, such an index is not yet monitored in the SR.

I. Mortgage Credit in European Countries

Mortgage Loan Market

A primary indicator by which the importance of mortgage credit in any economy can be judged, is the proportion of mortgage debt (mortgage credit) to gross domestic product (GDP). The value of this ratio varies considerably among European countries. From 1983 onwards, several countries have shown a growing mortgage debt to GDP ratio.

Table 1

Mortgage debt/GDP

Country	1983	1996
UK	28 %	61 %
DK	57 %	59 %
SE	5 %	58 %
NL	30 %	54 %
DE	41 %	48 %
IE	4 %	26 %
PT	8 %	22 %
BE	16 %	21 %
FR	15 %	20 %
ES	8 %	19 %
IT	2 %	7 %
GR	6 %	5 %
NO	30 %	43 %

Source: *EC Mortgage Federation, Brussels 1997; Empirica, Bonn 1997.*

The differences in the level of mortgage debt are due to several factors, such as e.g. the degree of urbanisation, the cost of living in rented or owner-occupied flats and family houses, the process of making mortgage loans (their terms and conditions), interest rate levels and consumer protection. In countries where execution mortgage rights and changing ownership is found to be complicated and problematic (France, Italy, Spain), the proportion of mortgage credit to GDP is low. On the other hand, in countries where creditors are in a better position when enforcing their rights, this ratio is much higher.

In respect of the level of interest rate and ”availability” of mortgage credit to the public at large, a well-known relationship will hold true: the higher the nominal interest rate, the less accessible the mortgage loans are. This relationship was much more noticeable in the years 1991-1992. Over the period 1993-1996, a tendency towards a gradual levelling of interest rates became evident. A sharp decline was recorded especially in Portugal, Spain and Italy.

The affordability of mortgage credit facilities, maturity period and terms and conditions for granting a mortgage loan, in particular the one for purchasing one's own home, are determined by the price of the flat or the family house and income of the household. The level of residential property prices influence the average amount of mortgage credit.

Table 2

Mortgage interest rates

Year	Portugal	Spain	Italy
1991	20.5 %	15.0 %	14.5 %
1992	19.8 %	15.4 %	15.7 %
1993	15.5 %	11.2 %	11.0 %
1994	13.0 %	10.3 %	11.0 %
1995	12.7 %	9.0 %	12.4 %
1996	11.5 %	6.6 %	9.0 %

Source: *EC Mortgage Federation 1997*

In 1996, the highest average amount of mortgage credit was recorded in the Netherlands – equalling ECU 77,600, and the lowest in Greece – ECU 22,400.

Table 3

Selected ratios for 1994

Country	LTV	C/P	Maturity
BE	61 %	2.46	20
DK	80 %	2.18	30
DE	69 %	7.22	28
ES	80 %	4.66	15
FR	61 %	2.54	15
IT	39 %	3.00	15
NL	72 %	3.47	30
PE	80 %	6.61	25
UK	73 %	2.92	25

Source: *EC Mortgage Federation 1997*
LTV – the proportion of mortgage credit to the value of real property (loan-to-value ratio)
P/I - the real property purchase price to household income

The relatively high level of prices of residential property to household income in Germany has contributed to the relatively low degree of ownership (people living in their own homes) and to the relatively high mortgage credit to GDP ratio. Over the period surveyed, the average purchase price of a house was DM 226,927, with a household income per year being DM 31,445, an average amount of mortgage loan of DM 157,224, and an interest rate level of 8.8%. Portugal and Spain also reported high levels, but at the same time the mortgage debt recorded there was low.

A different aspect emerges when we compare mortgage lending activities. Differences between gross and net credit levels in respective periods are caused prevailingly by the early repayment of loans as a result of decreased mortgage interest rates. The use of variable rate mortgages (and their modifications) should generally lead to a lower level of early repayment and diminishing differences between gross and net credits. A stable environment for the development of interest rates and their generally declining levels create room for the wider use of fixed rate mortgage loans.

Table 4

Mortgage loans for housing and business purposes (including loans converted to new loans) over a respective period

Gross credit[4], million ECU			
Country	**1995**	**1996**	**1997**
BE	6 314	10 601	13 541
DK	19 152	28 820	31 866
GR	232	389	461
ES	27 849	34 323	45 615
IT		26 399	22 075
LU	1 422	1 316	1 383
NL	49 215	57 814	68 813
AT	1 243	1 233	1 178

Table 5

Net credit,[5] million ECU			
Country	**1995**	**1996**	**1997**
BE	1 196	3 093	3 091
DK	3 587	5 106	7 096
DE	72 015	88 073	73 774
GR	118	236	531
ES	11 447	15 156	22 909
IE	1 641	2 244	3 649
IT		4 019	
NL	19 876	31 137	30 528
AT	417	221	309
PT	3 376	4 476	5 722
SE	-924	3 122	-894
NO	1 461	5 214	8 275

[4] The total amount (value) of loans made during the course of a respective period.
[5] Changes in the amount of mortgage loans in circulation over the course of a respective period.

Table 6

Mortgage loans in circulation,[6] million ECU			
Country	**1995**	**1996**	**1997**
BE	50 023	51 506	53 748
DK	107 834	111 880	123 477
DE	1 018 228	1 075 669	1 128 817
GR	2 173	2 424	2 929
ES	113 535	125 209	145 662
IE	13 535	17 067	20 189
IT	98 606	110 194	111 440
NL	213 906	238 108	263 981
AT	9 244	9 185	9 354
PT	18 038	21 850	27 946
SE	114 274	117 490	115 572
No	83 596	91 497	99 296

- **the number of newly made mortgage loans**

Table 7

a) for housing and business purposes

Country	1995	1996	1997
BE	111 500	178 028	225 712
DK	217 288	285 547	330 528
GR	12 508	16 773	17 106
ES	460 000	471 300	498 100
NL	440 311	518 951	585 887
PT	62 344	78 817	96 156

Table 8

b) for housing

Country	1995	1996	1997
BE	105 876	169 928	215 580
DK	193 906	250 987	292 543
GR	11 988	16 383	16 843
ES	400 000	413 000	435 600
IE	47 035	56 009	57 901
NL	389 602	485 473	553 613
PT	98 072	121 999	157 302
UK	909 000	1 085 000	1 267 000

[6] The amount of mortgage loans on the balance sheet of mortgage lenders as of the end of a respective period

Mortgage Lenders

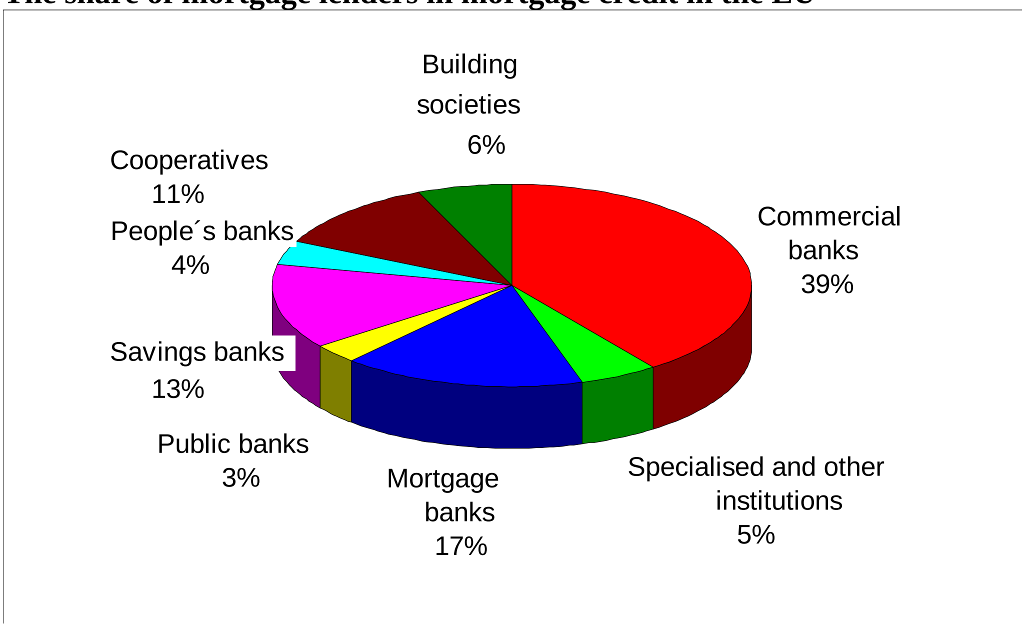
There are several financial institutions making mortgage loans operating in the European financial market. They feature commercial banks (Belgium, the Netherlands, Portugal), building societies (Ireland, Great Britain, Germany, Austria), savings banks (Germany, Spain), co-operative banks (the Netherlands, France, Germany), state-owned banks (Greece, Portugal, Germany), specialised mortgage banks (Germany, Denmark). The position of individual mortgage lenders in the market is documented in the following table.

Table 9

The share of mortgage lenders in mortgage credit in the EU

Mortgagees	% share	Mortgagees	% share
Commercial banks	39	Building societies	6
Mortgage banks	16	People's banks	4
Savings banks	13	Public banks	3
Cooperatives	11	Specialised and other institutions	5

The share of mortgage lenders in mortgage credit in the EU



The institutional set-up of mortgage lenders and their particular shares in the mortgage credit market vary, by and large as a result of their historical development, but also of the latest trends. So, for example in Ireland and Great Britain building societies (quasi banks) transact banking business along basically the same lines as commercial banks, many of them having been converted into commercial banks. The share of building societies in the market in Great Britain has dropped to approximately 25% compared to approximately 59% in 1996. In the majority of cases, mortgage banks in the Netherlands, Spain, Sweden, and also in Germany are owned by commercial banks. Building societies' saving schemes and credit provision linked thereto are supported by individual governments – by way of tax relief and subsidies, which also has an influence on their position in the domestic market. The development of the capital market is leading to the greater engagement of these banks that raise funds directly in this market. Last, but not least, increasing competition in respect of the supply of mortgage products has been causing changes in the relative shares of individual mortgage lenders in the mortgage market.

Mortgage Credit Products and Risks

At the forefront of any assessment of the supply of mortgage products is the question of the effective allocation of loans and risks, and in particular the risk associated with interest rates. Credit risk is linked to the proportion of the mortgage loan amount to the value of the property and to the level of instalment payments to income. These ratios are determined prior to the signing of a loan agreement (during the qualifying stage). Although being specified in the contract, they may change over time – due to altered terms and conditions of the contract, a changed financial position of the debtor or the property value. At a constant price of a mortgaged property and annuity repayment of a mortgage loan, the mortgage loan to property value ratio decreases hand in hand with reducing debt. Interest-only loans are more risky from the aforementioned point of view. In the same way, loans carrying shorter terms are less risky than long-term loans. The transfer of credit risk to a third party using different mortgage credit insurance schemes is for example employed in the Netherlands, Ireland and Great Britain. A mortgagor may get a more risky loan, with the ratio of loan to property value reaching high levels in many instances (above 80% through to 100%), but he must have the loan insured with a private insurance company (Ireland, Great Britain) or a government agency (the Netherlands). Even though mortgage insurance widens opportunities for obtaining a loan, on the other hand it makes comparison and selection of an appropriate product more complicated.

Credit risk (its allocation) is determined through the process of adjusting the mortgage interest rate to the situation and development of market interest rates. The increase in instalment payments that may for instance occur in the case of variable rate mortgage products in effect raises the risk of a failure to repay the loan. The risk of a failure to repay the loan is higher the more frequent interest rate changes are. Of course, an opposite relationship will hold true as well: interest rate changes of a lower frequency will increase the mortgagee's risk. Several types of mortgage credit products – mortgages are in use in the European Market:

- with a long-term fixed interest rate – fixed for a period of 5 to 30 years; e.g. France (15 years), Denmark (20 and 30 years), Germany (a maximum of 10 years), Greece, Italy;
- with a medium-term fixed interest rate – fixed for 2 – 5 years; Belgium, the Netherlands, Germany; also Great Britain and Ireland;
- with a variable interest rate – adjusted on a periodic basis (e.g. an annual basis) and using a specified index;[7] Italy, Spain, Portugal, France, Norway;
- with an adjustable interest rate – adjusted or revised as decided by the creditor, with no index to apply when fixing the "new" interest rate being specified in the loan agreement; Great Britain, Ireland.

Table 10

Interest rates on newly made mortgage loans

Country	**Year 1997**			
	I	**II**	**III**	**IV**
BE (1)	6.9	7.2	7.2	7.6
DK (2)	8.0	7.6	7.5	7.2
DE (3)	6.8	6.9	6.8	6.7
GR (4)	14.3	13.0	11.3	11.3
ES (5)	5.9	5.8	5.6	5.6
FR (6)	7.0	6.7	6.6	6.5
IE (7)	7.1	7.6	7.6	7.5
IT (8)	8.1	8.7	7.7	7.2
LU (9)	5.5	5.5	5.5	5.5
NL (10)	6.0	6.0	6.0	6.0
AT (11)	6.0	5.8	5.5	5.5
PT (12)	10.4	9.7	9.2	8.0
SE (13)	6.2	6.1	6.7	6.2

[7] The essence of mortgages with relatively flexible interest rates is to minimise interest rate risk undertaken by a mortgage lender. What is characteristic about these products is that the interest rate varies over the course of the loan maturity - e.g. each year. Indexing in case of an interest rate that is being adjusted to market conditions means determining it on the basis of an interest rate of e.g. Treasury bills with the maturity of only year plus a margin (T-bills - interest rate of 5.25% plus a standard fixed margin of 2.75% = 8%.). An effective interest rate, i.e. the rate applicable over a specified period of its change, may be different from the 8% in our example. The difference is that the so-called cap - a maximum allowable interest rate - is determined, for example of 1% per year (the periodic cap) and of 5% over the loan life. For an initial mortgage interest rate of 6% the maximum interest rate of 7% could be set for the second year. The maximum interest rate over the loan life would be 11%. The period cap is also applied to interest rate decreases (the maximum decrease during the adjustment period).

UK (14)	6.7	7.0	7.5	7.6
NO (15)	6.0	5.8	6.2	6.3

Explanatory notes

(1) - the so-called reference rate, revised once every five years after the lapse of the first ten-year period (a weighted average calculated on an accrual basis) which concerns loans secured by residential property only of the first rank, with a maturity of 20 years – with the loan to real property value ratio being 60-80%;

(2) - a fixed interest rate, calculated for the year 1997 on the basis of 30-year bonds – 7%, with a maturity of 30 years;

(3) - the so-called effective fixed rate (an average for a 10-year period) that includes other banking costs (as prescribed by regulatory rules), with a maximum maturity of 30 years;

(4) - a fixed nominal rate with terms and conditions fixed for 15 years;

(5) - an effective average interest rate, less other costs, changing each year depending on an official reference rate, where the mortgage loans are designated for housing purposes (with and without state subsides);

(6) - a fixed rate on loans where the agreement is required to be signed by the government, with an average maturity of 15 years;

(7) - a revised rate, with a maximum loan life of 30 years;

(8) - an interest rate fixed throughout the loan life;

(9) - a rate charged to the public sector;

(10) - an interest rate on mortgage loans guaranteed by the National Mortgage Guarantee Foundation revised every 5 years;

(11) - a reassessed rate;

(12) - a weighted average mortgage interest rate charged by all mortgage lenders;

(13) - a specific rate fixed for 2 years, where the maximum loan life is 30 years;

(14) - a weighted average gross mortgage interest rate on all mortgage loans made by large building societies;

(15) - an interest rate on new loans, fixed for a period of 2 years, an average reported as of the end of the respective quarter, including additional costs.

The calculation of interest rates is not uniform, which is related to the use of different types of products in the particular market of an individual country. Despite the lack of more detailed data on the share of different types of mortgages in domestic markets, it is possible to draw some general conclusions:

- in countries where the so-called deposit model is in place, the mortgage market is dominated by deposit institutions (commercial banks, building societies, savings banks) and flexible or adjustable rate mortgages are used to a larger extent (Great Britain, Ireland, Norway, Portugal, Spain)[8];
- in countries where the so-called mortgage bond model has developed, and where specialised mortgage banks dominate the market, products with a long-term or medium-term interest rate are employed (Denmark, Germany, Sweden);

[8] Due to an abrupt decline in interest rates in Portugal and Spain in the 90‘s, the proportion of products at a fixed and variable interest rate has changed in favour of those carrying a variable rate. Debtors who have concluded a contract for a fixed interest rate had to bear a high risk. The Spanish government adopted a statutory provision whereby debtors were enabled to switch to another creditor, i.e. repay the old loan early. Prior to this early repayment had not been allowed.

- in countries where a mixture of both models is in place or where the level of incentives is relatively high, fixed rate mortgages prevail (France would be a typical example);
- in countries where until recently the use of flexible mortgage interest rates was forbidden, or where mortgage banks held a significant position in the market, fixed rate products prevail (Belgium; the Netherlands).

Transaction Cost

Mortgage credit products carry with them additional transaction costs,[9] due to which the products become more expensive at the end of the day. The specific nature of a mortgage loan also ”necessitates” specific fees - such as the fees for property valuation, notarial fees for entering a mortgage in the land register (the register of charges), various administrative fees, mortgage loan insurance, and so forth. These are either charged separately or directly incorporated into the interest rate. For example, a fee for the registration of a mortgage deed and notarial fees range from 0,4% (the Netherlands) through to 4% (Belgium) of the mortgage loan amount. For illustration a more detailed summary of the level of additional costs associated with mortgage loans is shown below, with reference to the example of selected countries:

a) Belgium

- **valuation –** the cost of appraising the real property is to be covered by the loan applicant. If the service is rendered by an independent expert, the fees and costs associated with the valuation are paid directly by the mortgagor to the valuer. If the valuation is arranged by the bank, the cost is set at 0.30% of the loan principal amount;
- **commission –** a mortgagee has the right to charge a commission of no more than 0.50% of the sum borrowed; the commission amount must however be clearly stated in a separate clause;
- **drafting a mortgage deed and notarial fees –** the fees are fixed, levied based on the loan amount with the use of degressive tariffs. The cost of drafting a mortgage deed comprises stamp duty fees, revaluation of the mortgaged property, plans and data from the cadastral survey, postage, other fees;
- **registration fee –** accounts for 1% of the nominal loan amount plus accessories (10% of the principal).

[9] High transaction costs are one of the factors limiting cross-border activities within the EC. In some instances these range between 10% - 20% of the real estate property purchase price.

b) Denmark

- **valuation –** usually set at DKK 700 or 1,000 depending on the loan amount;
- **commission –** the amount of commission paid by a mortgagor to a mortgage bank includes the cost associated with the loan application concerned, or a Loan Agreement (loan terms and conditions), different administrative costs and the cost of raising statutory and other reserve funds. The total commission accounts for 1% of the loan amount plus 2% of the repayment amount for the so-called ”contributions” towards the creation of reserve funds. If a counsellor at law is engaged in the process of preparing the mortgage credit, the fee for his services will be charged in accordance with a common practice, namely in relation to the mortgage principal; with the specified fixed amount varying between different institutions;
- **drafting a mortgage deed and notarial fees –** mortgage credit institutions draft mortgage deeds on their own, with no fees charged for this service;
- **registration fee –** accounts for 1,5% of the mortgage nominal value plus DKK 300 per document.

c) Germany

- **valuation –** in principle, the cost of appraising the property is born by the mortgagor, with the fees being determined on the basis of a property valuation report to be submitted by a qualified valuer;
- **commission –** where a mortgage loan is negotiated via a third party, the commission is covered by the bank in a single payment;
- **registration fee –** notarial fees paid for extracts from the land register, permission to enter the charge and for the registration of a mortgage are fixed, with the calculation made based on the loan amount; these fees are paid by the mortgagor.

d) France

- **valuation –** 1% of the amount of the loan provided (for loans made by Crédit Foncier, min. FRF 700, max. FRF 1500). Purchases of property for use as own homes supported by the state or subsidised loans for rented housing are also written into the level of valuation fees – 0.30% or 0.50% of the loan amount;

- **commission** – in limited cases, the so-called commitment fee - commission for blocking loanable funds is charged as part of common transactions (loans made by Crédit Foncier, loans made for construction or reconstruction purposes);
- **registration fee** – mortgage loans are recorded in the so-called notarial instruments (giving rise to contractual relationships). The cost associated with the preparation of such documents comprises notarial fees, stamp duty fees, fees for an entry in the mortgage register. The level of **notarial fees** is calculated on the basis of the loan amount and in accordance with determined scales or coefficients that can be applied to the calculation. Such fees are also referred to as proportional. Included here also are fees for formalities, such as making out copies, duplicates, and so forth. The cost of certification and stamp duties – FRF 30 per a two-page sheet plus a fixed registration tax (FRF 430 in 1990). Fees for recording a mortgage in the mortgage register are derived from the loan amount plus supplementary services. Total costs for selected loan amounts are given in Table 11. Some types of mortgage loans are exempted from such fees, or the fees charged on these loans are lower than the standard (building savings and loans made by building societies, loans made by a mortgage institution – Crédit Foncier; social loans, special construction loans. See Table 12).

Table 11

Total additional transaction costs

Loan amount	Cost of contractual mortgages	% of the loan amount
70 000 FRF	4 100 FRF	5.86
100 000 FRF	4 800 FRF	4.80
150 000 FRF	5 500 FRF	3.66
200 000 FRF	6 900 FRF	3.45
300 000 FRF	8 300 FRF	2.76
400 000 FRF	9 000 FRF	2.25
500 000 FRF	10 300 FRF	2.06
750 000 FRF	13 700 FRF	1.80

Source: *EC Mortgage Federation, Crédit Foncier, own calculations*

Table 12

Total additional costs (exemptions, preferential treatment)

Loan amount	% of the loan amount
70 000 FRF	3.29
100 000 FRF	2.60
150 000 FRF	2.07
200 000 FRF	1.80
300 000 FRF	1.30
400 000 FRF	1.35
500 000 FRF	1.22
750 000 FRF	1.05

Source: *EC Mortgage Federation, Crédit Foncier, own calculations*

e) The Netherlands

- **valuation** – the valuation cost ranges between 0.125% - 0.2% of the property value. As a rule, it is covered by the mortgagor.
- **commission** – fixed at no more than 0.5% of the amount of loan provided;
- **drafting a mortgage deed and notarial fees** – there is no cost associated with the documents themselves. Notarial fees are determined on the basis of a fixed and descending scale, depending on the mortgage loan amount;
- **registration fee** – where the level of fees depends on the mortgage amount.

Incentives

European governments support the development of **home ownership** through a system of tax benefits (indirect intervention) or subsidies (direct intervention). The results of a survey of 1998 made by the EC Mortgage Federation confirm that tax relief represents the most common form of facilitating ownership of flats and family houses. In the majority of member countries it is possible to deduct interest charges from the taxable income base, either in full or in part:

Denmark	All types of interest are fully deductible.
Germany	Mortgage interest does not qualify as an item deductible from the taxable income base.
Greece	Mortgage interest constitutes a deductible item (the first purchase of property).
Spain	A deduction of 20% of interest and capital payments (25% for the first 2 years) from the tax to be paid, up to the amount of ESP 750,000, and of 15% from a further ESP 750,000 ESP (with effect from 1 January 1999)

France	A deduction of 25% of interest on a new property up to the amount of FRF 20,000 for a single person; 25% interest on a new property up to the amount of FRF 40,000 for a married couple; 25% of interest on an existing property up to the amount of FRF 15,000; these amounts will vary depending on the number of dependants.
Netherlands	Mortgage interest is fully deductible.
Portugal	The deduction of interest and capital payments up to the amount of PTE 297,000 (this amount is determined each year) is allowable.
Austria	Mortgage interest in combination with other costs can be deducted up to the amount of ATS 40,000 (for a taxable person); up to the amount of ATS 80,000 (for a household with one source of income).
Great Britain	10% of interest paid on the first GBP 30,000 of the mortgage loan amount can be deducted.

Source*:* *EC MF, Brussels 1998*

Direct support of mortgage lending is primarily channelled through the subsidising of interest and provision of government guarantees. Interest subsidies lower the price of mortgage loans, contribute to the recovery of the mortgage market and last but not least help to reduce the credit risk. An exclusive right possessed by selected mortgage lenders to make loans at interest rates lower than the market ones, allows them to seize a more advantageous position in the market (price, competitive advantage). French deposit institutions (commercial banks, co-operative banks, savings banks), who are the only entities authorised to take contractual savings deposits (analogous to building saving products), could be used as an example. Interest charged on such products is lower than on time deposits, which in turn is reflected in the level of interest rates on loans provided for housing purposes.

A special problem for the mortgage business is the issue of early repayment. The existence of the right of a mortgagor to repay early the loan provided to them is a factor that cannot be overlooked when determining the level of costs (interest rates, all the fees and charges; contractual penalties for accelerated payment).

Early Repayment

The right of early repayment allows a debtor firstly, to refinance a mortgage loan – where refinancing at a lower interest rate in the same or another institution is quite typical, secondly, to repay the loan from one's own financial resources. Losses incurred by a creditor due to the reinvestment may be many times higher compared to other costs (or risks). In this respect such uncertainties are termed reinvestment risk or the risk of early repayment.

A debtor's universal right to early repayment is based on the following arguments (Consumer Credit Directive, Article 8):

- a consumer should be protected against an excess financial burden (difficult life situations), e.g. when becoming widowed or divorced, in the event of a forced sale of the house (a change of employment, unemployment). In such cases early repayment should facilitate the search for new (affordable) debt financing;
- a consumer should be guaranteed financial and physical mobility, which may conflict with a distraint, the cancellation of a long-term financial contract. In the event of selling a residential property early repayment should contribute towards making the whole process more flexible and procuring new housing;
- a consumer should have the right to share in a favourable development of interest rates, as well as his creditor's competitive advantage.

The application of the right to early repayment in EC member countries may be briefly summarised as follows:

- it is possible to repay a mortgage loan in an accelerated manner at the time when an interest rate is fixed; the right to early repayment must be laid down in a mortgage loan agreement (Ireland, Belgium, the Netherlands, Portugal, Spain,..). It is a common practice to have bottom thresholds set on the amount that may be repaid earlier than scheduled.
- the early repayment is left to the parties' discretion when concluding a contract (the so-called ”general rules of freedom to contract”). Early repayment is excluded in Germany and Austria for a period not exceeding 10 years.

- this right is limited by the existence of penalties for early repayment of varying structure. The penalties for early repayment are interpreted in the following way: 1) as compensation for losses on the assets side or for lost profit (the Netherlands, Sweden), 2) as a price set in the contract in relation to the amount to be repaid earlier than scheduled(Belgium, France, Greece, Germany, Austria, Spain).

The application of the right to repay a mortgage loan earlier than scheduled is not uniform in member countries. The lack of uniformity is caused not only by differing legal frameworks for mortgage lending, but also consumer protection systems (along with other factors). Credit refinancing generally aims to protect a consumer against excess credit risk (fixed rate products). Member countries respect this goal, although approaches to reducing this risk differ.

France

The situation in the French real property and mortgage markets has been favourable since second half of the 90's. Prices and mortgage interest rates have dropped significantly. The introduction of the so-called "0 % credit" in the financial market laid fine foundations for securing housing needs. On the other hand, households remain afraid of taking on long-term debt, especially due to low economic growth, high unemployment and uncertainty about the future. The rate of home ownership is relatively stable – being 54% and fluctuating below the average for EC countries (60 %).

In the years 1995-1996 the mortgage loan market recorded growth, housing loans grew to 35%, reaching the value of FRF 310 billion (which also includes loans concluded again with the same or another bank, but under different conditions). In 1996, the mortgage business was positively influenced by the adoption of the following measures:

- *reducing a local tax on flat or house purchases from 7% to 5 %;*
- *extending the possibility to use a credit connected with building saving products also for the further purchase of flats or houses (not only for the first purchase);*
- *a loosening of conditions for getting the 0 % loan (not only for the first purchase).*

In 1997 interest rates dropped again, which was shown in the total amount of mortgage loans – FRF 330 billion. In respect of the use of fixed and variable rate mortgage products it needs to be emphasised that the situation started to change in 1986. Until then fixed interest rates had prevailed. The 1996 year was interesting, since a share of variable rate mortgage loans (which are guaranteed loans) of 25 % was recorded. The share of variable rate mortgages in the open market is approximately 50 % for banks and approximately 80 % for specialised credit institutions. This growth is explained as follows:

- *the renewal of a standard relationship between short-term and long-term interest rates, with a resultant difference between variable and fixed interest rates – of approximately 200 percentage points;*
- *strong competition between banks and specialised institutions that concentrate on the use of variable rate products and are forced to raise refinancing resources in the money and capital markets, whilst banks raise these resources under more favourable conditions (from deposits). On the other hand, specialised institutions possess know-how, which enables them to offer a wide range of sophisticated and flexible mortgage products;*
- *a major part of variable rate mortgages contain protection against the risk of unrestricted growth:*
  - *by setting a threshold, e.g. an initial rate plus/minus 2 or 3 points; a low initial rate and high threshold or vice versa;*
  - *annuity indexing in combination with changed terms and conditions (time aspect).*

Despite new conditions the state support of housing financing is still significant in France. This is not only reflected in a wide offer of mortgage loans of a strongly social nature, but also in the total share of the so-called social ownership of flats or houses (which is approximately 20%). Two products, the Épargne-logement (EL) and the 0% loan could be used as an example.

EL is a loan connected with saving schemes; a credit institution will grant this loan subject to meeting conditions set in a saving agreement (it is a product comparable with our system of building savings). EL and 0% loans are subsidised by the state – based on a state interest subsidy a credit institution grants these loans at a lower interest rate, and in the case of the 0% loan the advantage concerns a loan maturity period or *a postponed repayment period. The purpose of the loan is the same, namely for the construction or purchase of new housing units, the purchase of existing units and their reconstruction, transformation of non-residential units to residential ones. The 0% loan is limited as to its amount. This limitation may take two different forms:*

- *the maximum amount – depends on the size of a family and locality. For a four-member family it is FRF 160,000 FRF in the Paris locality and FRF 100,000 in the rest of France;*
- *the amount is limited up to 1/3 of the total borrowed amount 1/5 of total cost (the cost of purchase plus the cost of reconstruction).*

A rule that beneficiaries with a lower income are eligible for a higher rate of subsidy applies. There are 7 income-dependent groups differentiated for this purpose (1 - 7, with group 1 having the lowest income).

In order to make credit institutions grant loans also to clients with a lower income, the state has set up the so-called loans for social ownership (social loans) - PAS. Creditors make loans at an interest rate below the market rate, since in the event of trouble the losses will be covered by the guarantee fund (Guarantee Fund for Social Ownership).

II. Mortgage Business and EU Law

Mortgage Bonds

One of the most important Directives of the European law for mortgage bonds is the European Commission Directive No 85/611/EEC, as amended, relating to collective investment in securities, also referred to as the Investment Directive (UCITS). The provisions of this directive contain rules, limitations on and opportunities for investing into securities. Besides generally applicable principles, the elements of the so-called ”preferential treatment” are incorporated therein. This basically concerns application of certain exemptions and modifications of investments limitations. The issue is raised here of setting criteria to decide on the inclusion of a certain security in the group to be treated on a preferential basis, with the possibility of applying exemptions for determining the limitations on the investment into securities of one issuer or a group of issuers.

With regard to this, Article 22 is conclusive, since its provisions, in particular those of paragraph (4), are considered as minimum requisites of a mortgage as defined by statutes (the European minimum standard for mortgages).

As early as 1985, the EC Mortgage Federation formulated the basic requirements concerning the harmonisation of legislation relating to mortgage bonds. It is possible to summarise the essential features of mortgage bonds that should be incorporated in national legal standards as follows:

- In economic terms a mortgage bond (MB) is a refinancing instrument. It is a bond issued based on loans secured by mortgages (the principle of cover). Competent national authorities are entitled to include claims secured (guaranteed) by public authorities in the group of mortgage credit.
- MBs may only be issued by credit institutions. Only credit institutions making mortgage loans and having a license to issue MBs in accordance with national legislation are authorised to offer such bonds for sale.
- The value of mortgage bonds in circulation backed by mortgage loans of any credit institutions, as well as interest rates on MLs and MBs must at least be equal. At the same time the application of the principle of ”substitute cover” should be made possible.
- Mortgage loans serving to cover mortgage bonds may only be provided up to the amount of an ”adequate” proportion of prudently ascertained value of a real property.

- Competent national authorities may appoint special supervision over the maintenance of a mortgage register, for example by introducing a special institute of a mortgage trustee or charge with this task a supervisory authority.
- Creditors - holders of these bonds are protected in the event of an issuer going bankrupt. The most suitable way of attaining the highest degree of protection is the application of a priority right in the event of a debtor's (credit institution's) bankruptcy.

Note: *The application of the principle of priority right is simpler in the case of specialised mortgage institutions, which is due to the narrower scope of their activities (they concentrate on providing MLs, issuing and selling of MBs).*

Article 22

(1) An investment undertaking may invest no more than 5 % of its assets in the securities issued by one issuer.
(2) Member States may raise the set limit to a maximum of 10 %. The total value of the securities in which an investment undertaking invests more than 5 % of its assets may not exceed 40 % of the value of its assets.
(3) Member States may raise the 5% limit to a maximum of 35% if the securities are issued or guaranteed by a Member State or by its local authorities, ...
(4) Member States may raise the 5 % limit to a maximum of 25 % in the case of certain bonds when these are issued by a credit institution which has its registered office in an EU Member States and under the statutes related to the protection of holders of such bonds is subject to special public supervision; sums deriving from the issue of these bonds must be invested in assets specified by law, which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the satisfaction of investors' claims.
If an investment undertaking invests more than 5 % of its assets in the bonds issued by one issuer, the total value of these investments may not exceed 80% of the value of the assets of the investment undertaking.
(5) The securities referred to in (3) and (4) shall not be taken into account for the purpose of calculating the limit of 40 % referred to in (2).
Investment limits contained in paragraphs 1, 2, 3 and 4 may not be combined and in no circumstances may they exceed 35 % of the investment undertaking's total assets.

Specific provisions on mortgages are also found in other EU directives. Under the directive on solvency ratios for credit institutions (89/647/EEC), bank bonds are assigned the risk weight of 20 %. At the same time it is possible to rate the bonds mentioned in Article 22 para. (4) of the UCITS directive at 10 %. Although this only applies to bonds issued prior to 1 January 1998, the lower risk weight may also be retained after 1998, if member countries deem it necessary in order to prevent a severe distortion of markets. Under Article 4 (1) of the Directive 92/121/EEC relating to large credit exposures, a limit on credit exposure to a client or a group of connected clients is set and which may not exceed 25 % of a credit institution's own funds. What is important for mortgage banks is that the Directive makes it possible for member states to exclude, either in full or in part, specific loans (mortgage and municipal loans) and bonds as per Article 22 (4) of the Investment Directive, meaning also mortgages, when calculating the maximum limit.

The process of liberalising and harmonising life and non-life insurance has had an indisputably positive impact on the formation of mutual relations between mortgage credit institutions and insurance companies. Directives relating to life and property insurance alike contain provisions under which insurance companies may invest a higher percentage of their assets into certain bonds (higher investment limits). Mortgage bonds enjoy a special position under Article 22 (4) of these directives.[10] Insurance companies may invest as much as 40 % of their reserves into specified bonds where the credit institution is seated in an EU member country; holders of bonds issued by it are protected; funds raised through the issue of bonds may only be applied to assets determined by law; claims from the assets cover obligations due from the bonds over the whole maturity period and in the event of the bank going bankrupt, holders of these bonds are satisfied on a priority basis.

In this context it needs to be noted that (transferable) securities issued or guaranteed by the state are not the only securities ”offering” maximum security (payoff of yields and principal redemption). Also other bonds, such as mortgage bonds can be classified into this group.

Example: *Under the Danish legislation, mortgage bonds issued by Danish specialised mortgage credit institutions are ranked at the same level as bonds issued or guaranteed by the state. The equal position of mortgage and government bonds is reflected in the rules for investment (investment limits), as well as when determining the application of reserves of pension funds and insurance companies. The equal treatment is based on the recognition that institutions specialised in providing mortgage loans and issuing mortgage bonds run a minimal risk of going bankrupt. The reduction of this risk is due to stringent legislation (principles of matching assets and liabilities, creation of reserves, ...). Even in the event of a mortgage bank going bankrupt, the bonds are redeemed thanks to joint liability of mortgage credit recipients or through the sale of mortgaged real properties. By way of analogy, this statement will also hold true for German* mortgages.

[10] For further details see Otmar Stöcker: EU Materials on Mortgage Loans and Bonds and Their Incorporation in the German Law. Presentation: the Association of German Mortgage Banks, Berlin 1998.

Since the criteria for including ”certain” bonds in a common category with government bonds or bonds guaranteed by the state vary between member countries and may change over time, lists of bonds considered to be equivalent to government bonds started to be prepared. Such lists are distributed to all member countries together with arguments given in favour of equal treatment. In case of need, discussions can be channelled through the respective commission.

Another example of a fact documenting the security and liquidity of mortgages is that the European Central Bank has included them among Tier One securities for the conduct of monetary operations of the Eurosystem, as they have met several criteria (the type of security, seat, the type and creditworthiness of the issuer, settlement activities of operations...).

Mortgage Loans

Special provisions on mortgage credit are contained in two directives, namely the Directive of 18 December 1989 on a solvency ratio for credit institutions (89/647/EEC) and the Directive of 21 December 1992 on the monitoring and control of large exposures of credit institutions (92/121/EEC).[11]

The solvency ratio directive lays down a minimum proportion of own funds (capital) of a bank and the value of its risk-weighted assets. Under Article 6 paragraph 1 subparagraph (c) loans secured by mortgage over residential real property that is or will be occupied or leased or will be leased in the future by the loan recipient himself, are assigned a 50% risk weight. As far as mortgage business loans go, these were originally assigned the risk weight of 100% with the exception of Germany, Denmark, Greece, and upon its accession to the EU, also Austria. A transitory period was set until 1 January 1996, with the lower risk weight of 50% only applying to specified business mortgage loans. The loan amount may not exceed 60% of the value of a prudently appraised real property (office buildings, multifunctional business properties) located in the territory of these states (Article 11 para. 4).

Upon intensive negotiations, the European Council for Economic and Financial Issues (Econfin) has reached a political agreement on the ”Common Opinion on the Risk Weighting of Business Mortgage Loans”. The transitory period will apply to all EU member countries and will be extended till 31 December 2006. Pursuant to this opinion all member countries should allow their credit institutions to rate business mortgage loans at the 50% risk weight:

[11] See: Paolo Clarotti: The ”Acquis Communautaire” in the Field of Mortgage Credit. A paper presented at an international workshop, Bratislava 1999.

- loans secured by a mortgage over office buildings (premises) and multifunctional business premises;
- located in the territory of one of the member states that have permitted such a 50% rating;
- stringent detailed regulations are in place. In cases where the valuation is based on a market value, a loan may only be assigned the risk weight of 50% if not exceeding 50% of the real property market value. In that case the market value will have to be appraised by two independent valuers and the loan amount will be determined on the basis of the lower market value (price) of the real property in question. In member countries where stringent criteria for determining the ”mortgage lending“ value of a real property are laid down in legal or administrative regulations, there are two options when it comes to applying the 50% risk weight: the loan amount will equal either 50% of the real property market value or 60% of the so-called mortgage lending value, depending on which of the two is lower.

Note: *The mortgage lending value has been legally defined so that only the permanent features of a real property are taken into account when making a thorough and transparent calculation.*

The large credit exposure directive (92/121/EEC) makes it possible for member countries to - either fully or partly - exclude some loans from the application of the provision under which a bank is not allowed to provide a loan exceeding 25% of its own funds to a client or a group of connected clients (Article 4 para. 1). Article 4 para. 7. subpara. (p) will apply to mortgage loans for housing purposes; the 50% limit on the value of the mortgaged real property is applied to calculations in respect of housing loans (where the real property is intended to provide housing).

EU Legislation on Mortgage Loans and Mortgages

EU legislation on credit institutions and banking supervision contain a number of special provisions on mortgage loans (2 directives) and mortgages (7 directives).

I. Mortgage loans

1. *Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions.*
2. *Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions.*

II. Mortgages bonds

1. *Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).*
2. *Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field.*
3. *Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions trading in securities.*
4. *Council Directive 92/96/EEC of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance (life insurance) and amending Directives 79/267/EEC and 90/619/EEC (Third Life Assurance Directive).*
5. *Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance (other than life insurance) and amending Directives 73/239/EEC and 88/357/EEC.*
6. *Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions.*
7. *Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions.*

III. Mortgage Systems in Selected Countries

Mortgage Business in Germany

Mortgages bonds are fixed-yield securities covered by cognate first-rate assets. Two types of such bonds exist in Germany, namely communal bonds (covered by public sector loans) and mortgage bonds (covered by mortgage loans). The underlying assets remain on the balance sheet of issuers in charge of their due servicing. Security, liquidity, rate of return are the attributes most frequently used when giving a justification of their attractiveness. In this context we shall name the decisive factors influencing the above given attributes:

1. Above-standard credit quality (or the quality of the assets used as cover, i.e. mortgage and municipal loans) - stringent legislation and regulations create preconditions for a secure debt instrument.[12] Basic principles, including the rules for secure conduct of mortgage business are contained in a separate law (the Act on German Mortgage Banks). Only those credit institutions which have obtained a license to conduct mortgage business are allowed to issue mortgage and communal bonds. The name "mortgage" is protected by law.
2. Register of charges - the obligation to keep this register enhances the security of mortgages. Each issue must correlate with a portfolio of refinanced mortgage loans, especially in terms of their nominal value, terms and conditions and maturity, interest rate and currency. An independent mortgage trustee (controller) monitors the register on a regular basis, overseeing compliance with statutory limits. Starting from 1 April 1998 the register of charges is no longer involved in the banks' bankruptcy process (the assets serving to cover mortgages are separated out from other assets). This means that even in the event of a bankruptcy there will be no risk of early repayment. Holders of mortgages have a priority right to have their claims satisfied. If the value of "backing" assets (collaterals) does not suffice to meet the claims of all holders of mortgages, a bank will be obliged to discharge its obligations vis-á-vis investors from its own capital. A debtor is not entitled to early repayment of the loan (again there is no risk of early redemption of a mortgage), which facilitates even further matching of the structure of a banking entity's assets and liabilities.
3. The principle of cover - at least 100% (see Table 6).

[12] It should be stressed that during their more than 200-year existence, no issue of mortgage bonds has "failed".

4. The value of bonds in circulation may not exceed 60 times the liable own funds (for universal banks with a permit to issue such bonds the limit is set at 48 times these funds).[13]
5. A prudent (conservative) valuation of real estate (collateral).
6. The loan to real estate value ratio is capped at 60%. Mortgage loans provided above this limit are not included in the so-called backed pool and are considered as loans of poorer quality (a lower-ranking mortgage).
7. Special banking supervision.
8. Mortgages are used as collateral in cases where the funds are borrowed from the German central bank (included among the so-called Lombard securities); they are deemed to be a secure way of investing the disposable funds of insurance companies and investment trusts.

Market for Mortgages

The importance of the German market for mortgages is undeniable, with their share in the domestic bond market being the highest, and within the European region the second highest, with the value of mortgages in circulation constantly increasing.

Bond market **Table 13**

Type of bonds	Value in DM, billion	%
Mortgages	1 773	37.5
Other bank bonds	905	19.2
Federal government bonds	1 195	25.3
Other bonds (public sector)	226	4.8
Corporate bonds	7	
Eurobonds	617	13.1

[13] Safety of mortgage products is also influenced by the situation in the real estate market. In this respect, the German market has not been recording any rapid price decreases, which is frequently attributed to conservative attitude of German owners of houses or flats.

Bond market

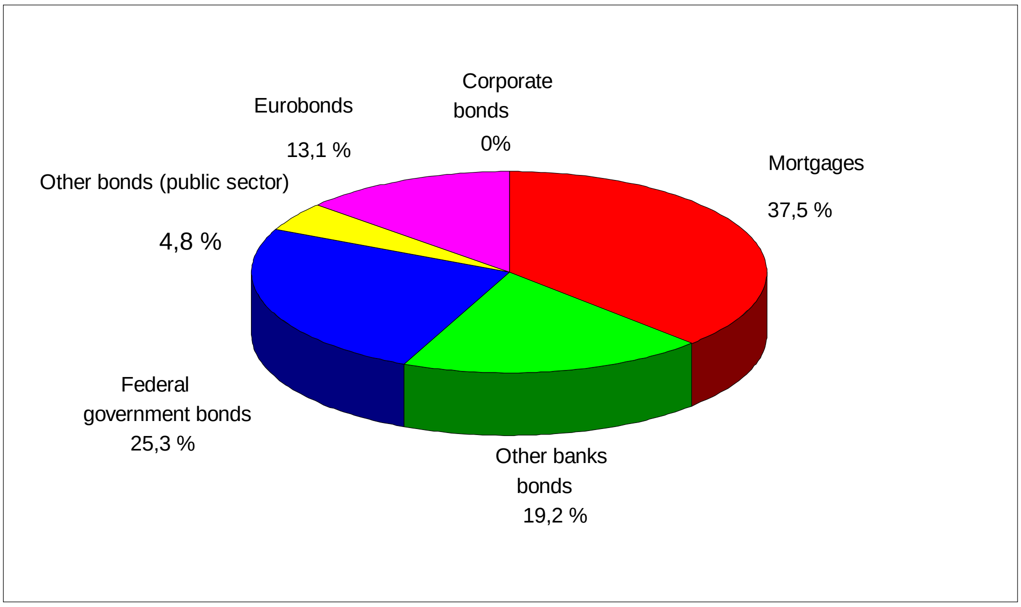


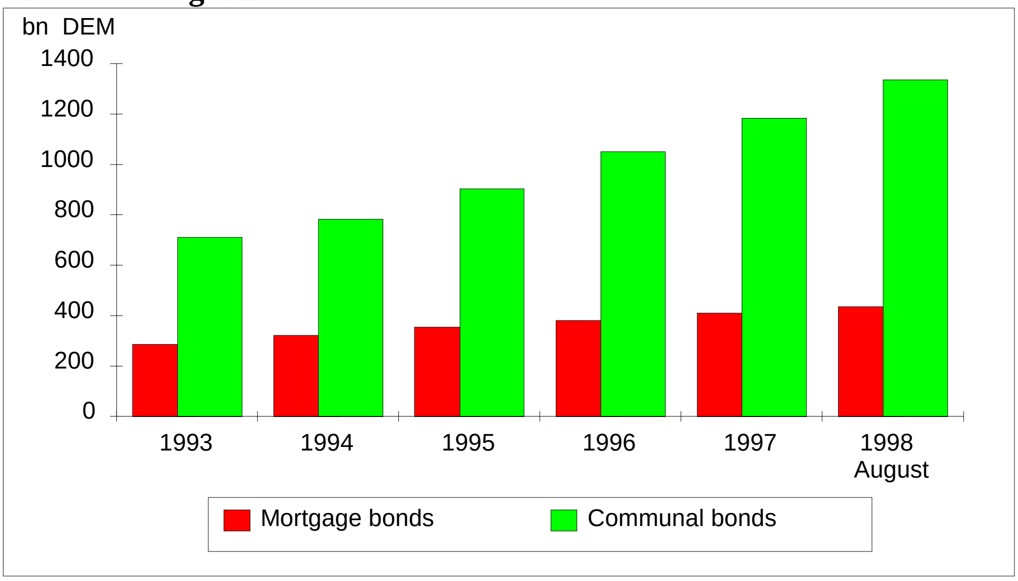
Table 14

Bond market growth

Period	Mortgage bonds (bn DEM)	Communal bonds (bn DEM)
1993	286	710
1994	322	782
1995	354	903
1996	381	1050
1997	410	1183
1998	443	1380

Source: *Association of German Mortgage Banks, Bonn, 1998;*

Bond market growth



The introduction of new products - the so-called "Jumbos" and "Globals" contributed towards the further increase of liquidity of mortgages and increased interest on the part of foreign investors in their purchase.

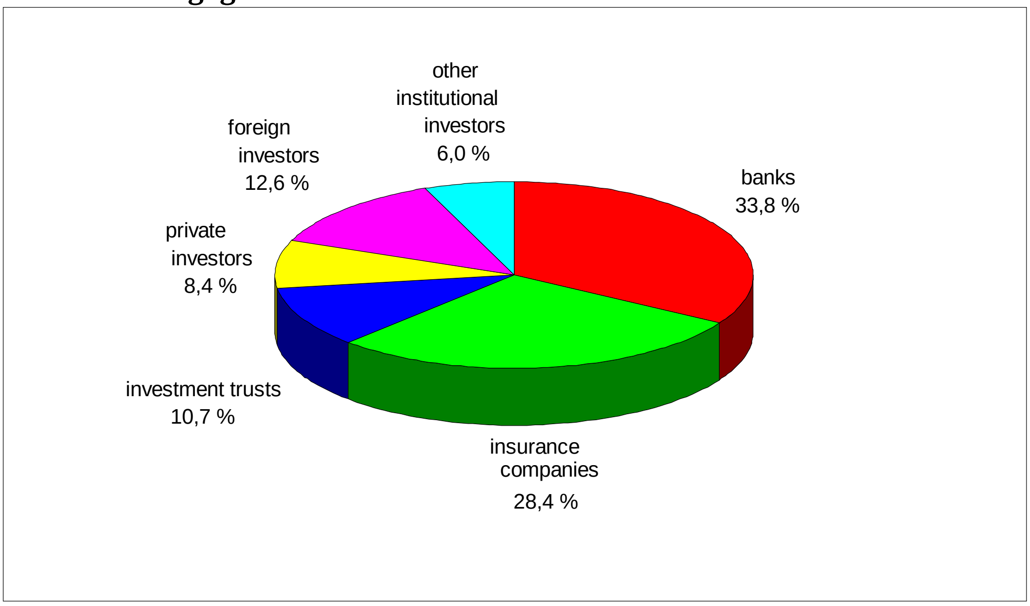
Table 15

Structure of German mortgage holders

German mortgage holders	% of the total value of mortgages
banks	33.8
insurance companies	28.4
investment trusts	10.7
other institutional investors	6.0
private investors	8.4
foreign investors	12.6

Source: *F. Munsberg, Budapest, November 1998. Data as at 31 December 1997.*
Note. *The share of foreign investors in the "Jumbo" market is expected to increase to approximately 25%.*

German mortgage holders



The basic differences between the so-called traditional mortgages and the so-called "Jumbos" may be summarised as follows:

Table 16

Attributes of mortgages	Traditional	Jumbo
Average issue amount	100-300 mn DEM	at least 1 bn DEM
Spread (bid-offer)	not defined	to maturity
		8 and more years: max. 10 Pf
		6-8 years: max. 8 Pf
		3-6 years : max. 6 Pf
		0-3 years : max. 5 Pf
Maturity period	1-15 years	1-15 years[14]

Note. *The so-called global bonds ("Globals") are basically "Jumbos" issued in selected international financial markets (the first four issues in the U.S.A markets; further issues listed e.g. on the Singapore stock exchange; denominated also in currencies other than the local one as well as in foreign currencies - e.g. in French francs, pounds sterling). Starting from January 1999 the redenomination of "Jumbos" to euro is scheduled.*

The growing interest in purchases of mortgages is to no small extent facilitated by a pool of quality information about, for instance the total value and distribution of assets used as cover, the value of regular and substitute cover, the type of real estate and its regional distribution, the mortgage credit amount, time structure, number of executions...

Table 17

Overall structure of the backing pool:

Regular cover	**Value in DM**	**% of mortgage bonds in circulation**
Mortgage loans	6 804 806 037	99.27
Substitute cover		
Cash	0	0.00
Claims against banks	50 235 650	0.73
Securities	200 125 000	2.92
Total cover	**7 055 166 687**	**102.92**
Mortgage bonds in circulation	**6 855 000 000**	**100.00**
In excess of cover	200 166 687	2.92

Source: *F. Munsberg: Security and Liquidity of German Mortgage Bonds, Budapest, November 1998.*

Approximately 51% of the total amount of mortgage loans went to the business field (office buildings, retail and wholesale networks - small operations, warehouses, hotels, and others) and the remaining part to housing (family houses 22.9%; multifamily houses 14.7%; rental houses, flats 9.7%). Almost 85% of mortgage loans have been placed in the domestic market (e.g. the Hessen country - 34.4%; Northern Westphalia - 28.9%, Bavaria - 9.4%; Lower Saxony - 6.4%; Saxony - 5.7%), and the rest on the foreign market (Great Britain - 9.7%; France - 3.4%; Spain - 3%).

[14] An increase to 20-30 years is envisaged.

Table 18

Distribution of mortgage loans by their amount

	Number	Value in DM	%
up to 0.25 mil DM	3 845	609 263 320	9
from 0.25-0.5 mn DM	3 125	1 181 596 875	17.4
from 0.5 - 1.0 mn DM	1 204	907 399 416	13.3
from 1.0 - 2.0 mn DM	845	1 323 466 885	19.4
from 2.0 - 5.0 mn DM	688	2 627 251 466	38.6
above 5.0 mn DM	25	155 828 075	2.3
Total	**9 732**	**6 804 806 037**	**100.0**

Loans for which delays in the instalment payments have been recorded account for only a very small percentage of the total mortgage loan portfolio. (See Table 7). Mortgage banks closely monitor the time structure of such loans, whereas the causes for such overdue payment or a failure to pay are found to be various. The most extreme solution is the exercise of mortgage over the real property, its sale via auction (both voluntary and involuntary).[15]

Table 19

Summary of overdue mortgage loans

	Number of MLs	**Value in DM**
Overdue for		
less than 2 weeks	21	11 925 795
2 - 4 weeks	54	47 443 806
1 - 2 weeks	48	21 819 264
2 - 3 months	32	15 664 640
above 3 months	30	19 763 340
Auctions	48	73 114 560
Total	**233**	**189 731 405**
% of total portfolio	**2,4**	**2,8**

Source: *F. Munsberg, Budapest November 1998*

In connection with the introduction of the euro the capital market is expected to widen and become more transparent, thus enabling investors to compare products more effectively, and to remove regulatory barriers in respect of the valuation of the market and taxation.

[15] Since clear „rules of the game“ are in place in Germany, i.e. parties to the relationship between a mortgagor, a mortgage bank and holders of mortgage bonds are familiarised with their statutory and contractual rights and obligations, exercising a mortgage does not pose any insurmountable problem. The violation of obligations arising from mortgage transactions may rather be seen as something exceptional, which is for instance reflected in the low proportion of amounts enforced via auctions to the mortgage loan portfolio - approx. 1%.

The bond market is an important segment especially in terms of funds raised by mortgage credit entities. According to several experts the euro will have a great influence on specialised mortgage banks that refinance mortgage loans either fully or prevailingly by issuing mortgage bonds (Germany, Denmark, Sweden). Mortgage bonds represent the largest category of securities following government ones. Their share in refinancing mortgage loans in Europe is estimated at 19%.

In this respect it has been mainly German mortgage banks who have exerted enormous effort to raise the market's liquidity, by increasing the volume of issues not only through the introduction of new products in the market ("Jumbos" and "Globals"), but also through striving to standardise these issues. Mortgage banks have "created" special indices for the German mortgage market - the PEX price index and the PEXP yield index that allow investors to gain information on prices of the main issues on a daily basis. This comes as no surprise, since Germany has the greatest market for mortgage bonds in Europe (46%), followed by Denmark (24%) and Sweden (12%) and the remainder divided between Italy, France and Austria.

Mortgage Business in Denmark

Financing of real estate and long-term capital projects is mainly realised by means of a mortgage. The Danish mortgage credit market may be characterised as follows:

- the credit is of a long-term nature and secured by real estate;
- the loans are provided in accordance with a specific law (the Mortgage Credit Act);
- the loans are financed through the issue and sale of special bonds - mortgage bonds that are not only an effective refinancing, but also an attractive investment instrument;
- the high level of protection for bondholders .[16]

At present, there are ten mortgage banks operating in the banking market, providing housing finance, including rented housing, business operations, agriculture, forestry, business and industrial investment.

Table 20

Mortgage business by categories of real property, bn DKK

	1997			1998		
Real property	**ML**	**NL**	**MB**	**ML**	**NL**	**MB**
1. Housing						
a) subsidised construction	**7.0**	**0.7**	**146.5**	**9.4**	**2.1**	**149.9**
b) private rental sector	**14.9**	**4.4**	**54.6**	**22.6**	**5.3**	**59.8**
c) flats, family houses	**145.7**	**42.4**	**519.4**	**220.4**	**47.5**	**570.9**
2. Business activities						
a) agriculture	30.0	3.7	117.2	47.3	6.3	123.5
b) industry and trade	13.2	0.5	35.7	15.9	-0.2	35.0
c) offices and business property	25.0	0.9	69.9	36.8	2.5	72.5
3. Other real property	**4.0**	**0.8**	**15.3**	**6.7**	**1.4**	**16.8**
Total	239.8	53.4	958.8	359.0	65.0	1028.4

Source: *Association of Danish Mortgage Banks, 1999*

The maximum limit on credit is determined according to real property categories and ranges from 40% (undeveloped areas) to 80% (owner-occupied houses and flats, privately rented houses, co-operative flats); the 60% limit is commonly applied to real property intended for business purposes except for agricultural property, where this limit is 70%.

[16] Over the course of 200-year history of mortgage credit, no holder of mortgage bonds ever incurred any loss due to a mortgage bank going bankrupt.

Table 21

Mortgage business by purpose in %

	1997			**1998**		
Purpose of financing	**ML**	**NL**	**MB**	**ML**	**NL**	**MB**
1. Housing	69.8	89.0	75.1	70.3	84.5	75.9
2.Business activities	28.4	9.6	23.2	27.9	13.2	22.5
3. Others	1.8	1.4	1.7	1.8	2.3	1.6
Total	100	100	100	100	100	100

The greatest portion of loans from the total portfolio goes to housing finance, the purpose of which is mainly to purchase one's own flat or family house. Special rules for financing the state-subsidised housing construction in the public not-for-profit sector are set each year by the Ministry of Construction and Housing (which gives an opportunity to respond flexibly and promptly to changing situations in the market). The maximum maturity period for mortgage loans is 30 years (and 35 years for the public sector).

Mortgage Bonds

The funds for mortgage lending are raised on a continuous basis through bond issues. A bank provides a mortgage loan with a given payment profile and maturity, while concurrently issuing an equivalent number of bonds of the same payment profile and maturity. Variable rate loans are as a rule financed via bonds with shorter maturities. The issuing of mortgages draws on the so-called balance principle, i.e. total loan repayments = total bond payouts. This principle is laid down in the Mortgage Credit Act and is one of the aspects of a bank's protection against credit risk. In this way, the risk undertaken by a mortgage bank is limited to the effective credit risk of a debtor (the debtor's performance of his obligations).

The high level of security of Danish mortgages is characterised as follows:

- they are covered by loans whose repayment is secured by a mortgage over a real estate;
- mortgage banks must keep the general balance principle, the application of which protects banks against credit risk;
- the capital adequacy ratio set for mortgage banks is the same as for commercial banks, i.e. at least 8%;
- the loan to real property value ratio is set by law depending on the real property category;
- mortgage banks are subject to stringent supervision;
- priority of holders of mortgage bonds;
- mortgage bonds have a high rating (AA2 and AA3 as determined by the Moody´s rating agency) and are considered to be a highly secure investment.

Mortgage bonds carry with them specific legal advantages resulting from the EU regulatory measures. Danish experts underline the fact that insurance companies are allowed to invest as much as 40% of their assets in bonds issued by one mortgage bank and these are classified into the pool of securities of the highest quality (Tier 1) when conducting operations with the European Central Bank.

Table 22

Placement of mortgage bonds in circulation, the end of 1998

Order	Investors	%
1.	Insurance companies and pension funds	35
2.	Financial institutions	25
3.	Public sector	13
4.	Households	9
5.	Foreign investors	8
6.	Other sectors	8

The data confirm that it is institutional investors - especially insurance companies and pension funds - who are the greatest purchasers of mortgage bonds, since they give preference to long-term investments that match their long-term liabilities.

The Danish market for bonds ranks among the largest, with the value of bonds in circulation totalling DKK 1,875 billion or EUR 252 billion at the end of 1998, of which mortgage bonds accounted for approximately 60%. For the sake of comparison, the value of mortgage bonds in circulation is given for selected countries.

Table 23

Mortgage bonds in circulation, mn ECU/EUR

				% GDP
Country	**1996**	**1997**	**1998**	**1998**
Denmark	127 385	135 118	147 407	94
Germany	154 218	166 232	180 793	9
Sweden	76 380	67 415	70 596	36
France	50 526	44 009	41 466	3
Spain	6 804	6 867	7 741	2
Austria	4 820	4 887	4 903	3
Netherlands	2 069	1 631	1 552	0

Source: *EU Mortgage Federation and OECD.*

The Danish bond market can be characterised by the following basic features:

- **it is liquid;** in 1998, approximately 2,500 bond series were listed on the Copenhagen stock exchange, of which 2,000 were mortgage bonds. The total market turnover in 1998 was EUR 1,096 billion, with a corresponding daily turnover averaging EUR 4.4 billion.

The volume traded is mainly concentrated in a small number of large series; of the total amount of mortgage bonds in circulation more than 25% belong to the 10 largest series. Basic mortgage bonds were represented by bonds at a nominal interest rate of 6% and 7% repayable in 2029.[17]

- **it is effective and transparent,** these features are ensured by a high-quality system of extensive information for all market participants (prices on a daily basis, yield before and after tax, the value of bonds in circulation, average interest; data on mortgage loans - backing pool, the structure of different groups of debtors, payment schedules,..).

Conclusion

Mortgage lending in countries of Western Europe represents a rapidly developing branch of bank lending operations. Over the period 1988 - 1999, the value of mortgage loans provided more than doubled, reaching an amount of approximately EUR 3 500 billion. Ranking among the countries with the largest markets are Germany, Great Britain, France and the Netherlands. Over the period surveyed, the greatest growth was recorded by Portugal, Spain, Ireland and the Netherlands. The expansion of the mortgage credit market is due to the action of several factors, in particular deregulation of the financial sector and historically low interest rates (the introduction of the single currency). Favourable economic conditions seem to be leading to an increased availability of mortgage credit and satisfying the high demand for housing. Despite this expansion, the importance of mortgage lending in European countries varies significantly. The proportion of mortgage debt to GDP ranges from 5 to 61%, while the average for the EU countries stood at 40% at the end of 1999.

Mortgage credit and real estate markets operate within national legal frameworks. The existing differences as to taxation, rules for providing incentives and protecting consumers, the fact that mortgage lending has always been considered as a ”national” banking business with different modes of providing mortgage loans, may continue to be considered as barriers to creating a single European mortgage market. Their gradual removal will however require a long time.

Deposits in general, and of these in particular personal deposits, are currently the most common method for refinancing mortgage loans. This refinancing instrument is expected to have to face increased competition in conditions where there are low interest rates.

[17] The majority of Danish mortgage bonds are issued at a fixed interest rate, with a maturity period of 20 or 30 years.

The process of convergence and lowering of mortgage interest rates in the EU 11 is continuing.

It is possible to state that at present (1999) their level has recorded an historic low. Among those countries where a considerable drop has occurred are Portugal (IQ 97 - 10.4%; IIIQ 99 - below 5%), Spain (IQ 97 - approx. 6%; IVQ 99 - approx. 4.2%) and Ireland (IQ 97 - approx. 7%; IVQ 99 - approx. 4.5%). The introduction of the single currency is considered to be a decisive factor in the future development of mortgage lending. The creation of conditions for a uniform, relatively stable capital market creates room for more active refinancing of mortgage loans using special mortgage instruments – mortgage bonds or mortgage backed securities. The integration of national capital markets into a single market will make a considerable reduction of costs and the development of new lending techniques (securitisation of mortgage loans) possible.

Despite the ”slow” pace at which the unification of legislative frameworks is proceeding, views as to the possible creation of a single mortgage market are optimistic, based on the introduction of the single currency as well as changing technologies, such as the use of the internet in mortgage business and the development of cross-border activities, especially in the field of business mortgage loans.

A N N E X E S

Basic Statistics

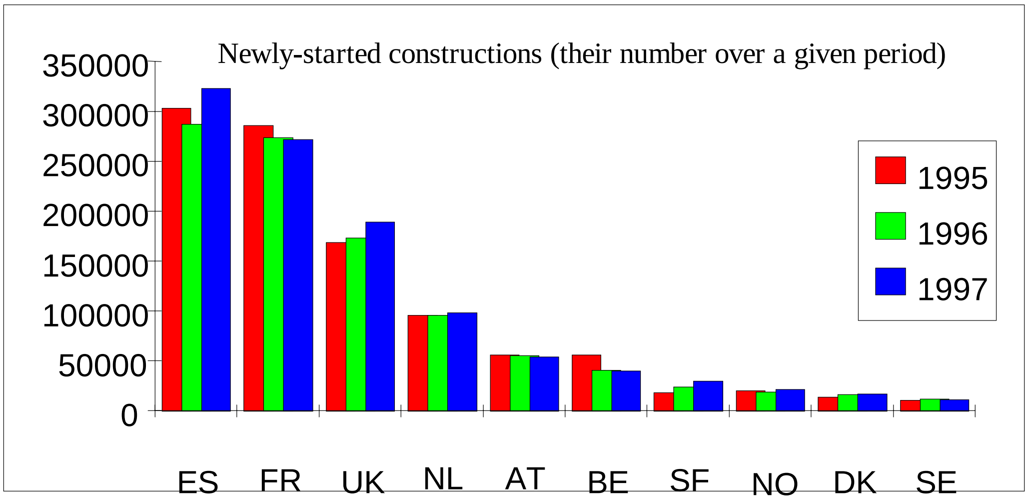
An important role in determining the level of investment in real estate in individual member countries of the European Union (EU) directed through mortgage credit is played by information on the real property markets.

1. Real Property Markets

- **newly-started constructions (their number over a given period):**

Country	1995	1996	1997
BE	55 800	40 700	39 600
DK	13 500	16 100	17 200
ES	302 900	286 800	322 700
FR	285 900	273 800	271 600
NL	95 900	95 800	98 000
AT	56 000	55 000	54 000
SF	18 300	23 600	29 800
SE	10 700	11 500	10 800
UK	168 300	173 000	189 100
NO	19 700	18 700	21 300

Newly-started constructions (their number over a given period)



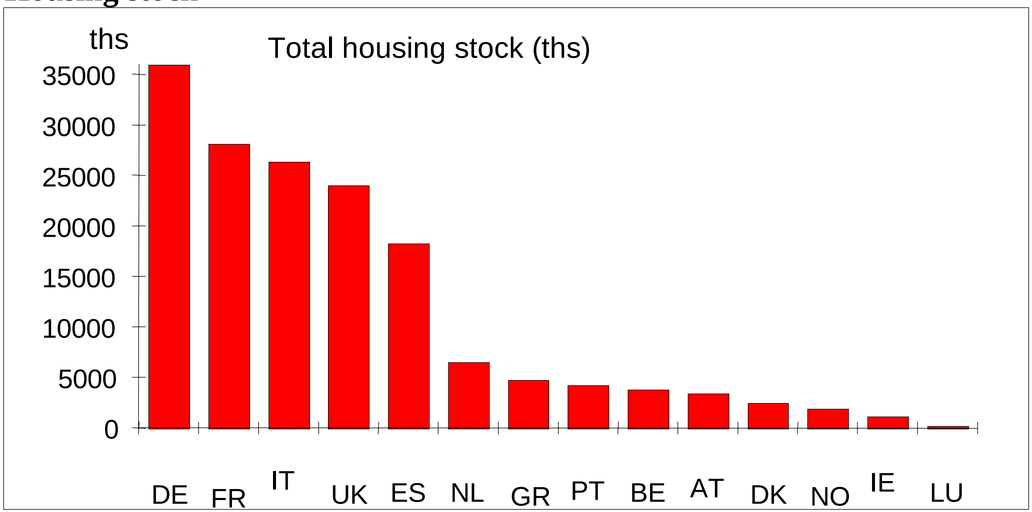
- **number of completed flats and houses:**

Country	1995	1996	1997
DE	603 000	560 600	570 600
ES	242 100	253 400	272 400
IE	30 600	33 700	38 800
NL	93 800	88 900	92 300
AT	53 400	54 000	53 000
PT	65 300	65 600	72 000
SF	25 000	20 800	26 200
SE	12 000	11 000	11 000
UK	190 500	179 100	177 700
NO	18 800	17 400	18 400
DK	13 500	13 700	16 400

- **total housing stock (number of units)**

Country	Number (ths)	Country	Number (ths)
BE	3 748	IT	26 300
DK	2 429	LU	145
DE	35 924	NL	6 441
GR	4 690	AT	3 370
ES	18 210	PT	4 181
FR	28 057	UK	23 998
IE	1 115	NO	1 830

Housing stock



- **trends in the development of prices of flats**

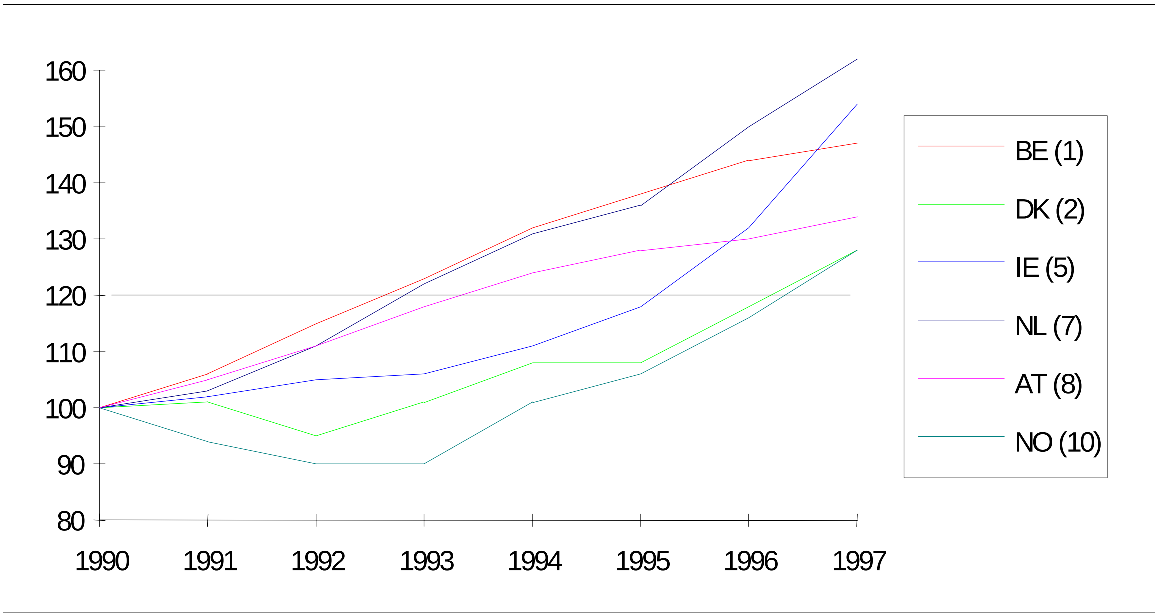
Nominal = Index 1990 = 100

Country	1991	1992	1993	1994	1995	1996	1997
BE (1)	106	115	123	132	138	144	147
DK (2)	101	95	101	108	108	118	128
ES (3)	114	113	112	113	117	120	121
FR (4)	95	99	104	108	102	101	
IE (5)	102	105	106	111	118	132	154
IT (6)	112	119	120	116	118	118	
NL (7)	103	111	122	131	136	150	162
AT (8)	105	111	118	124	128	130	134
SE	120	104	101	102	100	102	109
UK (9)	98	95	92	95	95	99	108
NO (10)	94	90	90	101	106	116	128
PT (11)			100	107	110	113	117

Explanatory notes: *(1) - average selling prices of existing dwellings (flats, smaller and middle-sized houses), 1997- first half of the year; (2) - prices of existing owner-occupied dwellings, 1997 - estimate; (3) - the price index for existing dwellings; (4) - the date refers to the existing dwellings procured by individuals on credit; (5) - average prices of new dwellings to be procured through approved mortgage loans; (6) - average prices of new and existing dwellings in large Italian cities; (7) - the price index for existing dwellings; (8) - selling prices of dwellings offered for sale at the Vienna real estate exchange; (9) - the mixed price index for all types of residential real property; (10) - the average price index for existing dwellings; (11) - average selling prices of all dwellings, index 1993 = 100.*

Note. *The term "dwelling" is used to denote a real property intended for housing, i.e. flats, blocks of flats and family houses. As follows from the explanatory notes, there are certain differences as to the construction of price indices; what matters more at this stage is that such a database already does exist in our country. Information on prices of real estate in the SR is very sporadic. The call for a price map is highly topical and extremely important (for fiscal authorities, banks, buyers, sellers, and so on).*

Trends in the development of prices of flats



Development of prices of residential real estate in Great Britain

Type	before 1919 (GBP)	1919-45 (GBP)	1946-60 (GBP)	after 1960 (GBP)	new (GBP)	total (GBP)
terraced houses	84 870	75 017	60 321	72 706	103 835	80 011
semidetached houses	126 750	88 939	73 176	70 508	76 358	83 949
detached houses	207 189	193 482	185 781	130 614	134 646	146 419
bungalows	72 078	110 690	102 294	85 423	90 107	92 213
flats and maisonettes	124 506	88 109	67 298	72 400	114 584	98 145
total	111 757	98 549	85 942	90 694	116 707	100 061

The price data in this Table has been calculated based on the arithmetic average of the prices of real estate purchased through a mortgage loan.

Selected indicators by real estate type, Index 1983=100

First purchase	index (1)	year-on-year change % (2)	stand. average price (3)	indust. credit GBP (4)	indust income GBP (5)	credit/income (6)	price/income (7)
1998	234.8	4.8	52 132	47 988	17 145	2.92	3.44
1999	250.8	6.8	55 668	54 590	18 983	2.97	3.52
All buyers							
1998	233.7	5.4	72 196	-	22 288r		3.24r
1999	250.5	7.2	77 405	-			
All buyers less first purchases							
1998	232.5	6.1	84 195	61 656	23 264	2.83	4.39
1999	249.5	7.3	90 367	70 759	25 542	2.93	4.58

Source: *Halifax, plc, Great Britain*

Explanatory notes. (1) - *the standard price index is seasonally adjusted. Seasonally adjusted data for the same month of the preceding year and the recent months are revised on a monthly basis; (2) -% change on the same period of the previous year; (3) - the calculation is based on average prices for a basis year, i.e. the year 1983, published each quarter in the "Housing Price Index" bulletin; (4) - non-standardised arithmetic average of loans; (5) - the average income in the UK concerns work done full time, the age of 21, all sectors and services and the calculation draws on a yearly summary of the development of income; (6), (7) - arithmetic averages of individual ratios; an arithmetic average of income earned by main loan applicants (non-standardised). Prior to January 1985, also additional income was included apart from main income in the total income; r - revised (adjusted).*

The following applies to the methodology and computation of standardised indices and average prices: indices are calculated separately, both on a regional and UK level for

a) new and existing houses and flats, b) clients who are buying a flat or a house for the first time and clients who have already owned such real estate, c) all real estate and all clients. A certain inconsistency as to figures, such as a % change for c) as compared to a) and b) may therefore arise.

Average prices for the basis year (which in Great Britain is the year 1983), broken down by (12) regions as well as by a), b) and c) constitute a basis for calculating standardised and seasonally adjusted standardised average prices for the given period. For example, the average price of residential real estate (all of its types plus all the buyers) in 1983 was GBP 30,898 x the index January 1998-222.2/100 = the standardised price - GBP 68,655 January 1998. In December 1999 the standardised average price amounted to GBP 83,108, the seasonally adjusted index to 269, the monthly change to 2.6% and the annual change to 13.6%. Despite the growing prices, the situation in the housing market is assessed positively and assuming further improvements in the economic situation, a relative stabilisation of the market is expected to occur in the year 2000. Despite higher interest rates and an expected decrease in demand, Halifax analysts expect the growth of prices of residential real estate to slow mildly in the last quarter of the year.

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