

## **Mortgage Insurance In Housing Finance – The Way To Go For Countries In Transition**

Dear Ladies and Gentlemen,

I have great pleasure of presenting you with housing mortgage insurance as a tool that may help solving a majority of housing finance related problems faced by transit economy countries.

First of all I would like to talk a little about the situation in Lithuania and about the company I represent.

Lithuania is an Eastern European country, one of the fifteen that previously belonged to the Soviet Union and gained its independence in 1991. Since then implementation of market economy has begun in the country. Many other Eastern European countries had started developing in the direction of market economy at a similar time. Currently the population of Lithuania is 3.5 million residents. The gross domestic product for the year 2000 was 111313.5 million USC and its increase over the latest years was 3.9 per cent.

The private housing in Lithuania as well in a majority of other Eastern European countries has developed in the period of 1990-2000. Since then the governments of countries in our region have started looking for solutions to housing finance problems.

A few words about the “Housing Mortgage Insurance” company. The company was established in the middle of the year 2000 by the Ministry of Finance of the Republic of Lithuania. The company insures the housing mortgages provided by the banks and other mortgage providing institutions that have contractual relationships with the company. In case the insurance recipient does not return the mortgage to the bank, the company covers the remaining amount of the unreturned mortgage by a 100 per cent. Once the insurance benefit is paid, the company overtakes the claim rights on the mortgage recipients property impawned from the bank and owns a right of covering the amount paid as an insurance benefit from the realisation of that property.

For a little more than a year the Company has insured over a 1200 mortgages. The general insurance portfolio of the Company amounts to 84 million USD.

In order to achieve a balanced housing market, housing finance in transit economy countries has to overcome certain specific issues that are in generally solved in most of the market economy countries. These issues that could be also called risks to be more precise could be divided into two groups:

- a) political
- b) economical.

I would like to go into these risks in more detail and start with the political ones:

1. weak regulation of rights on real estate;

2. inadequate legal acts regulating housing financed by mortgage applied in most countries;
3. macroeconomics related risk: a government usually has no possibility of assuring the growth of macroeconomics in the long run. As a result of such situation inflation, unemployment and instability of local currency risks occur.

Economical risks:

1. the risk related to property liquidity;
2. insufficient information about the market and potential mortgage recipients;
3. low income of the majority of residents;
4. insufficient finance for mortgages: shortage of funding to meet demand for mortgage loans on long duration.

Elimination of these issues would mean that all conditions to achieve successful housing finance are provided.

On the other hand, the financial institutions of transit economy countries are forced developing their activity despite the presence of risks listed above. As a result of such situation, mortgage providers apply all means possible to limit the risks related to their activity. For that reason most banks acting in transit economy countries set rather harsh requirements for mortgages provided – those much heavier than applied by financial institutions acting in market economy countries. A higher initial down payment. A much higher norm of interest rate applied, as well as a shorter mortgage term are among such requirements. While mentioning the interest rates applied, it is also important to take into account that they are initiated not only by high risks faced, but also the situation acute to most countries in transition when long-term mortgages are financed by short-term assets and the norm of interest rate is set on different basis from the funding rate.

The housing conditions standing in such environment may not satisfy the end user just as well. As the end result, there is no possibility of assuring the sufficient demand of mortgages. And of course, this negatively influences the housing finance market development. The problem becomes even more acute knowing that the majority of residents in transit economy countries receive low or average income. Even the 30 per cent initial down payment set, which is an amount that could be easily saved by a resident of a market economy countries is usually too high for a resident of a transit economy countries as saving opportunities are much more difficult. Analogically, high mortgage interest decreases the numbers of those wanting to receive mortgage.

The improvement of economical situation of most countries in transition, which is not always rapid but consistent provides great hopes that natural economical growth in the long run will sooner or later provide necessary conditions for financial institutions to provide housing mortgages upon conditions considered usual in countries of stable economy. Unfortunately, the practice shows, that economical development and stability requires a number of years to be achieved while residents cannot and don't have to wait for so long. While analysing the situation existing in transit economy countries, it is easy to come to a conclusion

that an artificial mechanism of guarantees that would help eliminating or decreasing most housing finance related risks faced by mortgage providers has to be developed in transit economy countries that have not enough guarantees as it is. The elimination of risks could result to more favourable conditions applied on housing mortgage. Such more favourable conditions on its own account would make the housing mortgage more accessible to a bigger number of residents. This way, an artificial mechanism of guarantees would allow anticipating the conditions of housing finance to those of usual to residents of developed countries over a shorter period of time.

The practice shows, that one of the most successful examples of such mechanisms are companies providing housing finance insurance or establishment of guarantee fund.

A natural question arises of who should take the responsibility of establishing such mechanism considering the unstable conditions of transit economy.

Estimating the load of macro economical and political risks in the general context of risks listed, it is easy to come to the most logical conclusion that the establishment of such mechanism should be initiated by state government. It is additionally supported by other reasons as well:

- a) the company controlled by the government is in a better position to take on political and credit risks that the government controls and by doing so gives the government an additional incentive to reduce these risks;
- b) The state owned company acting in the developing market has a possibility of initiating and offering the underwriting rules and risk assessment norms to mortgage providers and this way help solving housing finance standardization issues;
- c) The company managed by the state has a better approach to information about the potential mortgage recipients. It is acute at present as most countries in transition don't have a well functioning system (mortgage bureau) on mortgage recipients. Furthermore, the necessary information data bases or mortgage bureaus may be established on the basis of information managed by a mortgage insurance company as well as other information easier accessed by a state institution in comparison to a private capital companies;
- d) Most markets in transit economy countries as compared to Western countries are small-scale. This might mean that establishment of a private structure may have no basis because of a rather high establishment costs as compared to the market scale. Moreover, the mortgage insurance company has to have a rather high capital that would guarantee safety of the activity. Having a small-scale primary market such investment may be not useful.

Now we may talk about possible functional results of a mortgage insurance system in transition countries.

The current practise and the principles of activity of a mortgage insurance company provide, that the final wanted result is the appearance of mortgage accessible to a bigger number of residents in comparison to the situation without a

guarantee mechanism established, is achievable. This result is achievable due to banks receiving necessary guarantees on money return.

Let's look at these results in more detail.

Due to decrease of housing finance risks, one of the major means applied for provision on necessary means, which is the initial down payment, may be decreased. In general practice, banks without additional guarantees may efficiently function only in the set risk scale (for example, LTV – 70per cent.) Countries in transition face the situation of a higher instability so the property value may also fluctuate in a rather high scale. This means, that banks striving to avoid the risk of loosing on property value would request a higher initial down payment form a potential mortgage recipient. Having the additional safeguard from all of the risks mentions, the banks have an opportunity of decreasing an initial down payment.

The second important result achieved is the decrease of a mortgage interest norm. In the situation when the mortgage issued is insured, the bank has no need of in calculating risks into the mortgage interest norm. Furthermore, the insurance company by the premium paid may also cover the costs related to unreturned amount recovery. Having this opportunity of insuring the mortgages issued and this way eliminate most risks, banks are interested in insuring the majority of mortgages issued. In such situations interest norm discounts may be applied for such mortgages.

The third result is related to improvement of other mortgage conditions. As it was mentioned earlier, the initiation of housing mortgage insurance eliminates the housing finance of most risks and attracts mortgage providers. As a result, competition among the mortgage providers increases. And this situation could result to improvement of other mortgage provision conditions. This could apply not only to interest, but also penalties applying for delay of mortgage return, and etc.

To prove the efficiency of housing mortgage insurance activity in transit countries, I will provide you with Lithuania and it's experience in the field as an example.

Due to efforts in the field of housing finance applied one and a half years ago, the required initial downplayed that the mortgage recipient had to save up before the establishment of the mortgage insurance company dropped from 30 to 5 per cent. It is important to underline, that in most Eastern European countries (those neighbouring to Lithuania as well) the initial down payment remains as high as 30 per cent. Furthermore, the other mortgage conditions improved as well. Furthermore, the possibility to fully transfer the related risks to the mortgage insurance company has helped to increase the competition among the banks, as housing mortgages have become an attractive product to banks. A year and a half ago, the interest norm in the banks of the country for mortgages provided in USD have exceeded 11 per cent per year. Meanwhile, now in cases when mortgages are insured, the banks provide mortgages for less then 6 per cent annual interest. Banks have become more interested to have as many mortgages as possible insured, thus apply a 1 per cent point interest discount for insured mortgages.

Most banks do not apply the charge for prematurely returned mortgages or decrease it significantly.

The housing mortgage insurance efficiently solves housing finance related issues and is an effective cure from other problems faced by most countries in transition.

Due to housing mortgage insurance, the country consumption level may increase. Some transit countries to this day face a problem of residents feeling unsecured of tomorrow and thus decrease their consumption. A possibility to obtain housing having minimal initial down payment allows obtaining it at once without postponing it for the future, once the initial down payment would be saved up. Knowing the fact that obtaining housing is one of the largest purchases for most residents in value, it becomes obvious.

Having equal initial down payment, a person also taking a mortgage insurance has an opportunity of increasing an amount of mortgage received. This way, an opportunity to obtain a more expensive and better housing is provided. In Lithuania, as well as other transit economy countries, new housing costs more than the old. Thus, the statistics owned by us show, that the mortgage insurance is especially popular among residents obtaining new housing.

The higher number of newly developed housing, which inevitably appears once a mortgage insurance company starts functioning, positively influences the increase of housing construction scale, what is very acute for countries in transition at present. It becomes even more acute knowing that:

Very low levels of housing production for a long time in Eastern countries<sup>1</sup>.

□ For example, across the region housing production in 1999 was less than 40 percent of its 1990 level.

□ Moreover, one third of the countries are producing less than 20 percent of the 1990 level, and by 1999 none had reached its 1990 level.

The increase of housing construction scale solves other economical problems:

Following various calculations made, one job opening created in the field of construction, creates a number of other job openings in other fields of economy. It is believed so, that the multiplier of new job opening is the most effective in the field of construction. The gross domestic product is stimulated through the development of new job openings. It becomes even more important, taking into consideration the fact, that the gross domestic product for one resident in most transit countries is much smaller than that of market economy countries.

As it was already mentioned previously, a possibility to receive a rather high mortgage appears with the help of insurance and allows obtaining a modern and better housing with more efficient living costs management systems. This means, that the

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<sup>1</sup> Robert Buckley, 'Housing Finance in Transition Economies: Its Role in Poverty Alleviation and Private Sector Development', presentation on the international Conference in Vilnius, October 18, 2001

majority of residents income could be used not for paying various utilities but satisfying other needs. This positively influences the consumption internally and allows the more rapid growth of local industry and service sector.

The mortgage insurance in its nature is oriented to young and low-income families. Usually young families cannot obtain housing due to usually required high initial down payment. As the income of young families in transit economy countries is considered as rather low and the time frame for saving up for initial down payment is short, housing mortgage insurance becomes almost the one and only means for obtaining housing. My word may be backed up by statistical data. Before the housing mortgage insurance company has started functioning in Lithuania, the average age of a mortgage recipient was 34. Now it has become closer to 30.

The mortgage insurance in transit economy countries may be efficiently used also for solving other housing related problems while creating new housing finance schemes.

Residents in most Eastern European countries still live in apartment blocks build a number of years ago thus do not conform even to minimal energy saving and safety requirements. People with low and average income would not have an opportunity of improving the situation and renovate their apartment. On the other hand, this situation cannot be solved by the state either. The way to go about it could be provided with the help of bank mortgages. But legal acts of most transit economy countries do not assure banks with timely return of such mortgages. The major unsolved problem is related to pawned property and other guarantees necessary for such mortgages. As a result of such situation the absence of a pawned property in such projects does not allow banks financing renovation of apartment blocks. I think, this problem of insufficient guarantees may be solved with the help of guarantees provided by the mortgage insurance company.

The mortgage insurance may be successfully used in solving problems related to housing and social problems of elderly. The solution to such problems may be the Reverse Mortgage system applied in some Western countries. While receiving money for the housing owned, the elderly get an opportunity to renovate their housing and have some more money for their other needs. This is a very acute problem in most transit economy countries where the pension age residents have least social guarantees. It was noticed, that banks in transit economy countries due to high possible risks and related reasons usually avoid analysing such projects. The mortgage insurance could provide necessary guarantees for implementation of Reverse Mortgage.

As it was already mentioned earlier, a very acute problem that institutions providing housing mortgages in transit economy countries face is the lack of long-term financial sources for long-term housing finance schemes. I believe, mortgage insurance might be considered in a search of alternative financial sources for housing mortgages. The mortgage insurance company might participate in mortgage capitalization allowing for mortgage bonds or mortgage back securities. Actually, not only transition countries, but and others countries that can be characterised by growing mortgage markets are more actively looking for alternative methods instead of the traditional funding of mortgage loans. In cases when the market of deposits is insufficient for financing long-term housing mortgages, the capitalization of mortgages already issued

might stand as a solution of the problem. I would like to underline, that this is especially acute for transit economy countries where the market of deposit is small, as it was already mentioned previously, and the long-term mortgages are to this day usually financed by short-term actives. Securities like mortgage bonds and MBS can be attractive means of funding at an efficient cost of capital. The essential MBS or bonds requirement is to have a secure capitalisation basis. In transit economy countries it could be successfully achieved by insuring mortgages making up an MBS pool at a mortgage insurance company. Participation in MBS schemes is one of the strategic housing mortgage insurance aims of mortgage insurance companies.

In conclusion:

In my speech I have presented the possibilities of applying housing mortgage insurance mechanism as the major mean helping to successfully develop housing finance market in a transit economy countries. I hope the arguments and facts provided in my presentation have proved that the housing mortgage insurance is one of the most successful instruments in efficiently stimulating the growth of financing the housing markets in transit economy countries.

Thank you for your attention.