

# Mortgage financing - Increased housing welfare and financial stability in Latvia and Lithuania



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## **Danish – Latvian Mortgage Project**

Mortgage financing - Increased housing welfare and financial stability in Latvia and Lithuania

### **Housing welfare and financing:**

When the economy is growing and employment is rising, households increase their demand for housing, the income elasticity of housing is high. This increases the demand for housing finance. So do geographical mobility. Mobility on the other hand is crucial for structural adaptation. Structural adaptation is essential for high economic growth.

- In 2000, GDP growth was larger in Latvia and Lithuania than in Denmark and more important in the medium and long run the Baltic economies will harvest the advantage of catching up.
- The inflation rate was lower.
- The unemployment rate is still too high - and so are the interest rates.

There are problems with the quality of many of the existing dwellings in Latvia and Lithuania - too small size, poor construction, poor maintenance and insufficient infrastructure.

=> Potential demand for higher quality housing and increased demand for housing finance.

In 2000 mortgage loans in Denmark amounted to 87% of GDP, while in Latvia and Lithuania the corresponding figures was 3% respectively app. 1%.

### **The Danish Mortgage Credit System:**

Mortgage lending has existed in Denmark for more than 200 years, and so far, no Danish mortgage banks have ever defaulted on its obligations - although we have had several crises in the Danish economy and the real estate market.

The success of the mortgage credit system in Denmark is due to:

- The payment on the loan can be known and fixed - hereby the “rent” too.
- A loan does not require an up-front saving.
- The margins of interest are low compared with ordinary bank loans.
- There is no need for governmental subsidies.

The market has developed new products based on the same basic technique

- “Flex-loans” funded in the short end of the market. Cheaper funding cost but increased interest-risk for the borrower

- Reversed mortgages

**Limited risks on mortgage bonds => cheap funding:**

Pension funds and insurance companies are the principal groups of investors in mortgage bonds as the mortgage bond cash flows provide a good match for long-term insurance obligations.

The only risk associated with investment in mortgage bonds is the risk of a drop in market price. Therefore, mortgage bonds are classified as “gilt-edged” securities in line with government bonds with regard to statutory placement rules for insurance companies and institutional investors. Mortgage bonds also enjoy special legislative advantages as a consequence of EU regulations. They include that insurance companies may place up to 40 per cent of their assets in bonds issued by one single mortgage bank, and that mortgage bonds are recognised as securities of high quality (Tier 1) when loans are raised from the European Central Bank.

This implies official acknowledgement of the soundness of the mortgage banks and the mortgage bonds.

**Long-term mortgage bond financing enables affordability:**

Housing is one of the basic needs of the public - but it is very expensive.

In Latvia and Lithuania, mortgage loans are typically with variable interest rate, if fixed typically for maximum 2 years with refinancing possibilities.

In Denmark, a mortgage loan is typically fixed for 20-30 years.

A bond based mortgage loan in Denmark with variable interest rate, refixed every second year, will have an interest rate approximately 4 %-point lower than a corresponding mortgage loan granted by a commercial bank (not bond based).

If this is applied to the conditions in Latvia and Lithuania, it will imply a drop in the interest rate from approximately 11-12% to 7-8%.

In Denmark the spread between a fixed and a variable interest rate on a 30 years bond, based mortgage loan is approximately 2 %-point.

Normally the borrower will be interested in a loan with as long maturity as possible, since at the same loan-amount the yearly payments will be lower the longer maturity.

Funding of long-term fixed rate mortgage loans on the basis of variable rate deposits work well in a time of stable interest rate - but will break down in a time of high and fluctuating interest rates: Structural mis-match in the balance sheets of financial institutions are not good for financial stability.

=> Need for long-term funding and long-term loans.

**Challenges for Latvia and Lithuania:**

The privatisation process is nearly finished. Hereby the responsibility for the buildings are moved from the municipal or the state to the owners – and hereby the owners rights and duties too.

- The owners have the duty not only to cover all costs for his own dwelling but also his proportional ratio of the costs of the common expenditures for the entire apartment building.

- Calculations from Building Department in the Ministry of Environmental Protection have shown that there is a need of 25-40 Ls per m<sup>2</sup> for renovation in the dwelling stock in Latvia (probably the same situation in Lithuania).
- Special energy savings will create not only a better indoor climate but also a significant reduction of the energy costs for every single apartment owner and for the country as a whole. Accordingly, there ought to be a broad and potential fast growing market with a limited risk, since savings in the energy bill can cover financial cost.
- Implementation of energy savings, hereunder through insulation and maintenance has to be done in co-operation between the owners. Therefore, it is important to have a well-functioned financial system to provide necessary funds and credits to these common investments. It is also very important to have a well-functioned institutional system, which can create decisions taken by the apartment owners (House Owner Associations, etc.).

The establishment of the bond market is beneficial for transition countries not only to attract global capital to their housing finance markets, but also to suppress the high margins that banks are getting by increasing competition. This would enhance the availability of housing finance for larger portion of the population.

An effective mortgage lending system can provide longer-term funds for lenders than currently available, long-term funds in local currency and a limited risk investment for long-term investors (such as pension funds and life insurance companies). The continued transition process and pension reforms will increase the importance of institutional investors.

### **The Danish Mortgage Projects in Latvia and Lithuania:**

The Danish Government, through the Danish Ministry of Economic Affairs provides technical assistance in establishing sound and operating mortgage supervision in Latvia and Lithuania.

The aim of the projects is:

- To ensure that the necessary prudent legal framework is in place against which supervision can be performed.
- Evaluate the existing legislation and propose amendments.
- To ensure that the corresponding institutional structure in the supervision is in place.
- Develop staff requirements and job descriptions for the mortgage supervision.
- To ensure that the supervisory body has the necessary tools to perform the mortgage supervision.
- Develop written manuals/procedures for on-site inspections, requirements for a reporting system and analysis, etc.
- Develop national guidelines on valuation of real estate for mortgage lending purposes.
- Develop written procedures for performing valuation check-up in banks.
- Develop a real estate market information system to be used in the mortgage supervision (database containing information about the real estate market).
- To ensure that the correct individuals with sufficient knowledge and training are available to staff the supervisory function.
- Training of employees in supervision in valuation checks of real estate and in mortgage supervision.
- Training of real estate valuers in valuation for mortgage lending purposes in the form of seminars, workshops or on the job training.

It is of highest priority, that the recommendations reflect recognised international standards and comply with applicable EU directives.

The tasks is performed in close co-operation with Supervision as well as the market participants.

Developing of the framework will contribute significantly to financial stability.

**Conclusions:**

The growing economy will increase the demand for higher quality housing in Latvia and Lithuania.

Today there is a huge need for renovation and energy savings in the existing dwelling stock.

Increasing employment and the need for mobility will require a well-functioned housing market, in particular taking account of the very high level of private ownership.

In order to finance this Latvia and Lithuania will see an increasing demand for long-term financing in local currency and a demand for cheaper housing finance.

The income level of the population is however yet quite low and only a small portion of the public is regarded as financially eligible for loans. So much more interest in having the best possible framework for using the value of fixed property as collateral.

Furthermore there are interesting broad market segments like investments in energy saving.

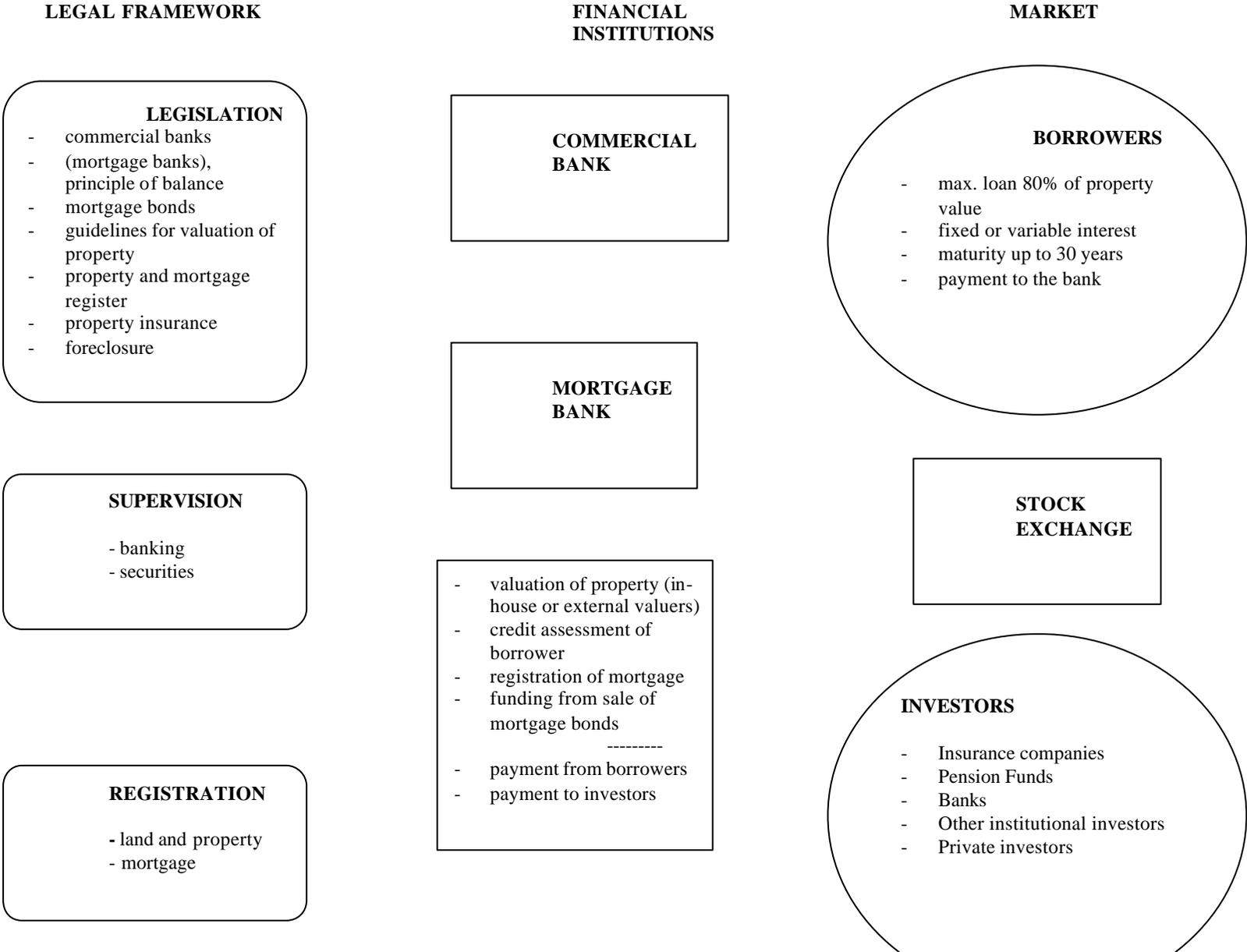
The development of pension funds and life insurance will increase the demand for long-term securities. A mortgage bond provides better diversification of investment portfolio and is regarded as safe long-term security.

The necessary framework for housing finance based on mortgage bonds both in relation to legislation and supervision will be in place here in Latvia in spring next year and according to our present work plans in Lithuania in the end of 2003. That is what can be done through public technical assistance. The rest is up to the market.

There is no doubt that there is a potential market for cheap, long-term loans to finance the development in the housing stock - now and in the future.

The first-mover will have the opportunity of building up a portfolio, which will place them in a good position in future - The financial industry has every possibility to take up the challenge now!

**THE BASIC LEGAL AND INSTITUTIONAL CORNERSTONES OF THE DANISH MORTGAGE CREDIT MODEL**



**LEGAL FRAMEWORK**

**LEGISLATION**

- commercial banks
- (mortgage banks), principle of balance
- mortgage bonds
- guidelines for valuation of property
- property and mortgage register
- property insurance
- foreclosure

**SUPERVISION**

- banking
- securities

**REGISTRATION**

- land and property
- mortgage

**FINANCIAL INSTITUTIONS**

**COMMERCIAL BANK**

**MORTGAGE BANK**

- valuation of property (in-house or external valuers)
- credit assessment of borrower
- registration of mortgage
- funding from sale of mortgage bonds
- -----
- payment from borrowers
- payment to investors

**MARKET**

**BORROWERS**

- max. loan 80% of property value
- fixed or variable interest
- maturity up to 30 years
- payment to the bank

**STOCK EXCHANGE**

**INVESTORS**

- Insurance companies
- Pension Funds
- Banks
- Other institutional investors
- Private investors

### BASIC DATA

Year 2000	DK	LV	LT
Population, 1.000 (January 1, 2000)	5 330	2 380	3 699
Over 60 years	20%	21%	19%
Unemployment rate	5,4%	7,8%	11,5%
GDP at current prices, million EURO	176 271	7 601	12 074
GDP per capita, EURO	33 071	3 194	3 265

Source: Statistics Denmark, Central Statistical Bureau of Latvia and Statistics Lithuania.

### HOUSING WELFARE

Year 2000	DK	LV	LT
Total dwelling stock, million m2	271	53	82
Total dwelling stock, 1.000	2 489	1 103	1 356
1 room	150	276	235
2 rooms	460	529	513
3 or more rooms	1 879	298	608
Gas	318	936	1 092
Bath	2 320	932	922
Central heating	2 443	927	968
New dwellings completed, 1.000 m2	2 361	219	507
New dwellings completed	15 814	1 351	4 463
Average number of inhabitants per dwelling	2,1	2,2	2,7
Average dwelling size per capita, m2	50,8	22,4	22,1
Average dwelling size, m2	109	48	60
Number of new dwellings per 1.000 inhabitants	3,0	0,6	1,2
Average size of new dwellings completed, m2	149	162	114
Per cent of dwellings with:			
1 room	6%	25%	17%
2 rooms	18%	48%	38%
3 or more rooms	75%	27%	45%
Per cent of dwellings with:			
Gas	13%	85%	81%
Bath	93%	85%	68%
Central heating	98%	84%	71%

## FINANCIAL STABILITY

Year 2000	DK	LV	LT
Consumption expenditure			
Food	11%	41%	48%
Housing, water, electricity, gas and fuels	28%	17%	12%
Total assets in banks, million EURO	418 516	4 933	3 781
Total loans in banks, million EURO	257 498	1 806	2 270
Total mortgage loans, million EURO*	153 149	197	167
* In DK and LT the banks do not register mortgage loans separately. DK = m-loans in mortgage banks. LT = information from Agricultural Bank.			
GDP growth	2,9%	6,6%	3,3%
Inflation, consumer prices	2,7%	2,6%	1,4%
Interest rate on short term deposits in national currency, 1999	2,4%	5,0%	4,9%
Interest rate on short term credits in national currency, 1999	7,1%	14,2%	13,0%
Loans per capita, 1.000 EURO	48,31	0,76	0,61
Loans as per cent of assets	62%	37%	60%
Mortgage loans as per cent of total loans	59%	11%	7%
Mortgage loans as per cent of GDP	87%	3%	1%
Mortgage loans per capita, EURO	28 733	83	45

Source: Statistics Denmark, Danish Financial Supervisory Authority, Central Bank of Denmark,  
Central Statistical Bureau of Latvia, Bank of Latvia,  
Statistics Lithuania and Bank of Lithuania.



## Housing welfare in 2000

	Denmark	Latvia	Lithuania
Number of persons in each dwelling	2.1	2.2	2.7
Average dwelling size, m <sup>2</sup>	109	48	60
New dwellings, m <sup>2</sup>	149	162	114
Dwellings with more than two rooms	75%	27%	45%
Dwellings without bath	7%	15%	32%
Dwellings without central heating	2%	16%	29%
Mortgage loan as per cent of GDP	87%	3%	1%

Source: Statistics Denmark, Central Statistical Bureau of Latvia and Statistics Lithuania.



## The Danish Mortgage Credit System

- Loans granted through the issue of bonds
- Bonds backed by mortgages
- Mortgages registered on the land register
- Callable bonds
- Different products:
  - Fixed interest rate and long maturity
  - Floating interest rate with refixing possibility
  - Reversed mortgage



## Limited risks on mortgage bonds => cheap funding

- The balance principle  
⇒ only credit risk
- Valuation rules
- Loan-to-value limits
- Bond owners' privilege



## Challenges for Latvia & Lithuania

- Well-functioned financial system
  - Competition => lower interest rates
  - Development of new products
- Well-functioned institutional system
  - Land Register
  - House Owner Associations
- Well-functioned housing market
  - Steady prices
  - Market for buying and selling



## The Danish Mortgage Projects in Latvian and Lithuanian

- Create the framework
  - Valuation rules
  - Sound and operating mortgage supervision
  - Practical training
  - EU compliance
- The framework will provide financial stability



## Conclusion

- Increasing demand for
  - Higher quality housing
    - Renovation and energy savings
    - Mobility
  - Long-term financing in local currency
  - Long-term securities
    - Pension Funds and life Insurance Companies
- ➔ Benefits for first-mover - The financial owned industry must take up the challenge now!



## Case-study: Financing of energy-renovation

- Mortgage in the dwelling
- No need for up-front savings
- Saved energy costs = repayment of loan