

REVIEW OF HOUSING MORTGAGE LENDING POLICY PRACTICES IN LATVIA

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Abstract

The aim of the research is to evaluate the housing mortgage lending policy development aspects in Latvia.

Research methodology: Analytical research method and comparative research method have been applied to carry out the research.

Findings of the research shows that housing mortgage lending policy system is well arranged and complies with European Union requirements in this field. However the development of housing mortgage lending market during the period after accession to the European Union and up to crisis in 2008 has created negative impact on development of the housing market in post-crisis period until today in Latvia.

Research limitations: In the research there are evaluated housing mortgage system legal and policy aspects and mortgage market trends in Latvia, but not made scientific discussion of the theoretical aspects of mortgage lending system in general.

Originality of the research is that author's find out that the task of government is to develop and implement financial mechanisms for multi-apartment building sector and combining them with the mortgage loans it would be possible significantly improve the housing situation in the country by providing affordable mortgage loans to households for the purchasing, construction and renovation of housing.

Keywords: housing policy, mortgage lending, mortgage lending market.

1. INTRODUCTION

The wish for better life has prompted many people to take mortgage loans in banks, intended especially for this reason, for purchase or renovation, reconstruction or repairs of the dwelling or private house (Research of Economical and Social Situation in the Baltic States: Latvia, 2013).

Furthermore the biggest problem in housing sector in general is unsatisfactory technical condition of multi-apartment buildings, because the most part of all multi-apartment buildings were built during the Soviet period (after 1993 it is built only around 11% of multi-apartment houses), which are characterized by construction technologies incompliance with modern requirements, small living space and other aspects what according to modern requirements require renewal and transformation of housing infrastructure. However, the problems have not yet reached results improving the general housing situation, because there are required significant investments in the long term (Henilane, 2015) and it is impossible to do without the support of the government. Effective housing mortgage lending policy development and implementation play the most important role for improving the housing situation in the state in general.

The subject of the paper is housing mortgage lending policy.

The aim of the research is to evaluate the housing mortgage lending policy development aspects in Latvia.

The research paper is structured in three parts. In the first part there are characterized and analyzed the main aspects of legal acts relating to housing mortgage lending system in Latvia. In the second part there are analyzed the results of the implementation of the housing mortgage policy in Latvia. In the third part there are analysed housing mortgage market development trends: the main problems and positive aspects.

In conclusion are made proposals for the government for the housing policy sector in context with the development of new financial mechanisms for providing affordable loans to households for the purchasing, construction and renovation of housing.

In research paper are applied the analytical research method and comparative research method.

2. REVIEW OF THE LEGAL BASIS IF MORTGAGE LENDING SYSTEM

In general mortgage lending system is characterized with the facts that it ensures long-term crediting, formation of mortgages and issue of bonds. Upon comparing with other lending systems the mortgage lending system is formed by trying to reach maximal balance between active crediting transactions (issue of credits) and passive transactions – re-financing of loans (attraction of new financial resources through assistance of mortgage bonds). In this way the problems related to possible insufficiency of financial resources in long-term are eliminated. Accurate balance between active and passive transactions within framework of mortgage lending system ensures constant and stable attraction of credit resources in long-term, as well as creates the opportunity to decrease the price for credit resources. Mortgage lending system is lending system within framework of which the banks on the base of obtained mortgage (immovable property pledge) issue special publically traded securities – mortgage bonds for coverage of which there are serving mortgage loans issued by the banks (Andrejeva, 2005).

Mortgage lending system aspects has been analysed and discussed by different researchers (Neilands, 2014; Ijevleva, 2014; Mazure, 2012; Lejniece, 2012; Andrejeva, 2005; Dubel, Rothmund, 2011; Friedemann, 2008 etc.) though most of them have basically analysed mortgage lending in relation to real estate or housing aspects.

The Law on Mortgage Bonds is the main regulatory enactment in Latvia what regulates issues related with mortgage lending. Mortgage loan is a loan (credit) what is secured with immovable property pledge (mortgage), registered in European Union member country. Its quantity along with other encumbrances registered for immovable property previously may not exceed 75 percent from market value of immovable property, the composition of which in at least in a half contains value of such building where at least a half of total space may be used for a living, or 60 percent from market value of immovable property of other type (Mortgage Bond Law, 1998).

Besides the Mortgage Bond Law the issue of mortgage loans in Latvia is being regulated by Civil Law, Civil Procedure Law, Credit Institutions Law, Land Register Law, Consumer Rights Protection Law, Solvency Law, and other regulatory enactments.

Civil Law is the oldest regulatory enactment which includes the norms including regulation of provisions, related to:

1. rights in rem to immovable property, including to pledging rights to immovable property, mortgage establishment and extension and discharge of mortgages;
2. rights regarding obligations to immovable property, including provisions regarding warranties, pledging rights, loan contract and loan repayment provisions, and other issues (The Civil Law, 1937).

Civil Procedure Law regulates the general rules of civil proceedings, rules of proceedings in first instance court, court judgments and appellation rules, and other issues relating to the proceedings in connection with failure to repay mortgage loans (Civil Procedure Law, 1998).

Credit Institution Law regulates the rules that apply to operation of credit institutions as well as credit provisions (Credit Institutions Law, 1995).

Land Register Law regulates the rules concerning corroboration of real estate in the Land Register (Land Register Law, 1937).

Consumer Right Protection Law regulates the rules concerning rights of the mortgage borrowers in case of mortgage loan repayment (Consumer Right Protection Law, 1999).

The most topical intended changes in regulatory enactments regarding operation of mortgage lending system in Latvia are associated with changes in relation to “throw away the key” principle or the principle where in case if mortgage borrower is not able to pay for the loan there is an alternative for him to return the pledged property to the bank and to get free from all debt liabilities. Changes in determination of mentioned principle applies only to amendments in the Insolvency Law, Consumers Right Protection Law, Law “On Personal Income Tax” and Law “On Enterprise Income Tax”, which is effective from 1 March 2015.

Taking into account the above mentioned the norm of Insolvency law is cancelled what means that along with 1 March 2015 by selling the property what has served as security the remaining debtor’s liabilities will be cleared along with approval of the auction. Such procedure would be applicable only to cases when in result of debtor’s insolvency his only home will be sold, and it would not be retrospective.

Amendments of Insolvency Law not only exclude “throw away the key” principle, but also change the term for clearance of natural person’s debt. Term for clearance of liabilities will be one year, if the debtor’s total liabilities after the bankruptcy procedure do not exceed 30000 euro; two years, if liabilities are from 30001 euro to 150000 euro, and three years from the announcement of liability clearance if liabilities exceed 150000 euro (Darzina, 2015; Saeima Press Service, 2015).

Along with amendments in Consumer Right Protection Law the “throw away the key” principle is determined as opportunity of selection by the borrower. Lender and consumer may agree in the loan agreement that transfer of security to the lender is sufficient to repay the loan. Lender upon receiving consumer’s loan offers to the consumer two types of loan agreements, one of which provides that transfer of security to the lender is sufficient to repay the loan, while the other one provides a complete consumer’s liability for repayment of the loan. Lender is entitled to apply different provisions for each type of draft loan agreements. In other words, by signing a loan agreement, it will be possible to agree with the creditor already from the beginning whether the performance of liabilities will include “throw away the key” principle. In case of “throw away the key” principle the banks apply higher rate of the first instalment and a higher interest rate, thus decreasing the risk for the banks.

Changes in above mentioned regulatory enactments regarding the implementation of “throw away the key” principle occurred because in September 2014 the credit institutions rejected participation in family housing programme and informed on increase of the first instalment and increase of interest rates arguing that the legislator has not yet evaluated the adverse effects of changes to mortgage lending, in result of which the access to credits will decrease due to increase of the initial payment and interest rates, whereas the decrease of credits will have a negative impact on the economy (Consumer Right Protection Law, 1999; Darzina, 2015).

By analyzing laws and regulations what regulate mortgage lending the author concludes that the latest changes in legislation show that the government more and more attention devotes to consumers’ rights and their protection in the event of mortgage borrowing in order to reduce cases of consumers’ bankruptcy, and thus to ensure their well-being and socio-economic situation in today’s society, at the same time imposing also stronger provisions for consumers in mortgage lending, and thus reducing also the risk for banks.

3. THE ANALYSIS OF MORTGAGE LENDING POLICY ASPECTS

The creation of the mortgage lending system was started in the end of 1997 with approval of Mortgage lending system conception. The aim of mortgage lending concept was to justify the need for the creation of mortgage lending system (Cabinet of Ministers of the Republic of Latvia, 1997).

Whereas, in the end of 2012 the management team of mortgage lending system implementation, created by the Ministry of Finance, concluded that mortgage lending system in Latvia in general is well arranged and complies with European Union requirements in this field (Ministry of Finance of the Republic of Latvia, 2012).

Hipoteku banka (Mortgage Bank) which operated in Latvia from 1993 by the end of 2013, and which was the only commercial bank wholly owned by the State during its existence, has had invaluable role in the development of mortgage lending system in Latvia. The Bank actively participated in the development of Latvian mortgage lending system, creation and development of mortgage-backed securities market, as well as in promotion of mortgage-backed securities (The state joint-stock company Altum, 2014).

Hipoteku banka implemented a range of various development programmes in various industries, including in the housing sector – Pilot programme and stage II of Housing development lending programme (hereafter - MAKP II). Within framework of MAKP II there were provided guaranties for housing loans, included to families with children for mortgage loans for the purchase or construction of dwelling (by 31.03.2008 there were issued 177 guaranties for total amount 2,7 million euro for loans in amount of 12,9 million euro); to lessees of denationalized houses and their family members if they use residential premises in denationalized house or in house what was returned to its legal owner, and they have used it by renewal of rights for mortgage loans for the purchase or construction of dwelling (by 31.03.2008 there were issued 4 guaranties for the amount 72 thousand euro for loans in amount of 316 thousand euro), and guaranties to associations of apartment owners for renovation or reconstruction of houses (no guaranty was issued). Regarding issue of guaranties for loans for renovation or reconstruction of multi-apartment houses, the commercial banks indicate that current funding of programme is small and determined fee for issue of guaranties for loans for renovation or reconstruction of multi-apartment houses (2.6 % annually from remaining guaranty) is disadvantageous (substantially higher than for similar services, for example, in Estonia) for apartment owners in multi-apartment houses). Implementation of the programme was terminated in 2010 due to lack of financial resources for further implementation of the programme (Informative report of Cabinet of Ministers, 2008).

Issue of guaranties by Hipoteku bank to commercial banks decreased credit risk and thus promoted development of mortgage lending.

Since 1 January 2014 Hipoteku bank is transformed as development institution by focusing its operation to directions which are important for national economy, and without performing commercial bank's transactions what are being executed by state joint stock company "The Latvian Development Finance Institution ALTUM" (The state joint-stock company Altum, 2014).

The most important funding for arrangement of housing sector is in way of grants is EU funds programme for 2007 – 2013 in framework of heat insulation of multi-apartment houses programme by performing heat insulation for around 850 multi-apartments buildings with total funding 89,20 million euro, and within framework of heat insulation of social residential houses programme by performing heat insulation for around 55 social residential houses with total funding 9,2 million euro, the administration of which is being performed by Investment

and Development Agency of Latvia. Loans were issued by Latvian commercial banks, but 50% of renovation costs were financed from European Regional Development Fund. In this case the residents took the loans in banks and cash flow of residents' payments served as a pledge, and it was not required to pledge the apartments, as well as there was needed support from more than 50% apartment owners for implementation of multi-apartment house renovation project (Regulations of Cabinet of Ministers No.284; Henilane, 2015).

Very important role has implementation of efficient financing model for new programme of EU funds 2014 – 2020 for multi-apartment heat insulation what currently is in development phase, in framework of which the funding in amount of 176,47 millions euro is available, what will be based on mortgage lending principles by giving the support in way of grants from resources of EU funds (the appropriate support mechanism is being specified). It is planned that within framework of new programme the association of apartment owners will apply to ALTUM for receiving a loan on favourable terms, and after reaching certain energy efficiency level after completion of house renovation project it will receive grant by up to 35% of project costs (Regulation project "Energy efficiency measures in residential buildings", 2014).

Within framework of the state support programme families for purchase or construction of dwellings it is planned that from 2015 will be granted around 220 guaranties on guaranty programme implementation in total amount of liabilities what does not exceed 1330 thousand euro, but also attraction of additional funding is planned. The aim of the programme is to provide the state guaranty to families with minor children for purchase or construction of dwelling in order to help with required co-funding - credit the first instalment for mortgage credit (Altum, 2014).

Taking into account the above mentioned the author concludes that mortgage lending has important role in the case of housing crediting. At the same time it should be concluded that financing of multi-apartment building sector in period of EU funds 2007-2013 and in the new planning period of EU funds 2014-2020 is not based on mortgage lending principles because apartment owners by taking the loan in bank do not pledge their apartments, but the financing principle is based on positive flow of residents' payments (for services, management). When drawing up the programme of EU funds 2014-2020 for financing of multi-apartment houses the most important task of housing policy makers is to find the most effective financing mechanisms, which, when combined with housing lending principles, would provide possibility to insulate as much multi-apartment houses as possible, thus improving the technical condition of the multi-apartment houses.

4. DEVELOPMENT TRENDS IN MORTGAGE LENDING MARKET

According to Hypostat data Latvian mortgage lending market is characterized by very rapid development of mortgage lending market during the period after Latvia joined the European Union in 2004, when mortgage lending volumes in the residential sector in 2005 constitute 2513 million euro, or by 2380 million euro more than in 2000 when mortgage loans in the housing fund were granted in amount of 133 million euro (Hypostat, 2014; Hypostat, 2011).

Following Latvian accession to the EU, Latvia had experienced a high level of GDP - from 2004 to 2007 GDP grew by 33%. Development of Latvia during this period was not based on correct principles - freely available and cheap foreign capital instead of investing in the economic development was mostly used for simple consumption, including the purchase of immovable properties. During this period the portfolio of mortgage loans experienced the fastest growth because it was simultaneous with construction boom, loans were easily

accessible and the value of immovable properties sharply increased. Lending boom and the rapidly growing real estate market contributed to an unprecedented demand for various types of imported products. As a result the import substantially exceeded the export, and the large current account deficit became one of the main precursors to the upcoming crisis (Research of Economical and Social Situation in the Baltic States: Latvia, 2013).

Taking into account the above mentioned, it should be pointed out that the mortgage market continued to grow rapidly until the global financial crisis in 2008, when the amount of granted loans in housing stock comprises 7136 million euro, or by 4623 million euro more than in 2005, when the total amount of granted mortgage loans comprises 2513 million euro. After the crisis from 2008 till 2013 the mortgage market in Latvia develop slowly and the amounts of outstanding mortgage loans for residential sector decreased with every year. In 2013 there were issued mortgage loans in value of 5062 million euro, or by 2074 million euro less than in 2008.

After comparing amounts of Latvian mortgage lending with Estonian and Lithuanian indicators, it should be concluded that Estonia during time period from 2000-2013 was a leader in the mortgage lending market among the Baltic countries, while Lithuania in mortgage lending market was behind Latvia from 2000-2011, but from 2012 due to the fact that amounts of Latvian mortgage lending decreased more rapidly than in Lithuania, the total amounts of Lithuanian mortgage lending were higher than in Latvia (Hypostat, 2014; Hypostat, 2011) (see Figure 1).

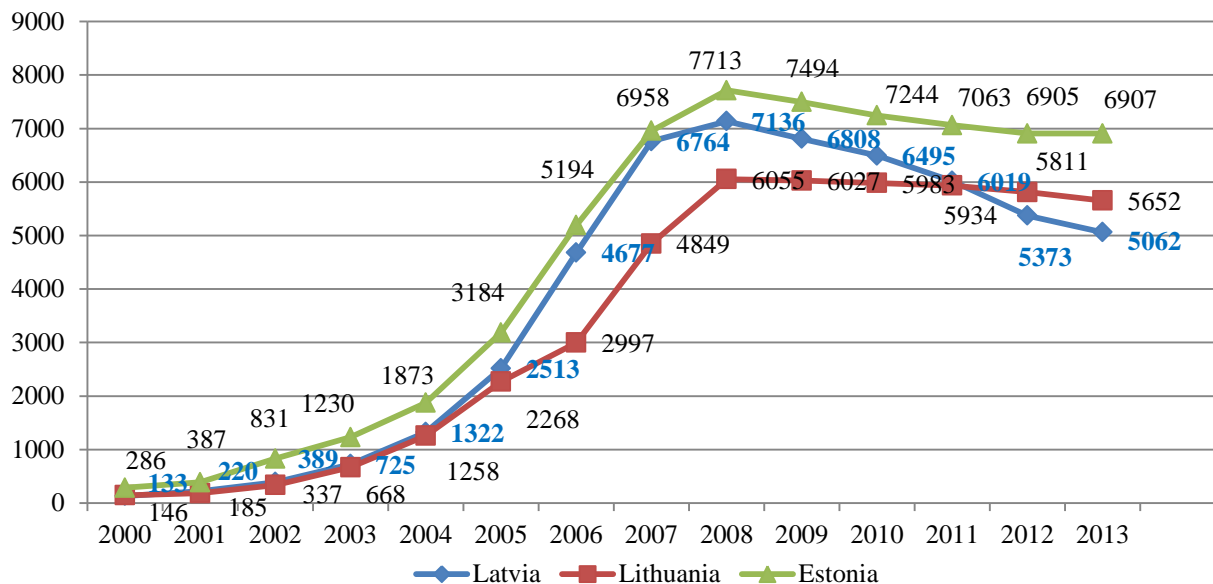


Figure 1. Total Outstanding Residential Mortgage Loans in the Baltic States, 2000-2013 (total amount, end of year, EUR million)

Upon assessing changes in interest rates for mortgage loans in Latvia in total, it should be concluded that from 2000 to 2013 they had substantially decreased, i.e., for more than 3.4 times: from 11.4% - in 2000 to 3.28% - in 2013. At the same time interest rates for mortgage loans in Latvia from 2000 to 2013 are the highest among Baltic countries, by comprising in 2000 – 11.40% (in Estonia – 9.93%, in Lithuania – 10.38%); in 2005 - 4.43% (in Estonia – 3.32%, in Lithuania – 3.27%), during post-crisis period, in 2009 – 4.88 (in Estonia – 4.17%; in Lithuania – 3.87%); in 2013 – 3.28% in Estonia – 2.39%, in Lithuania -2.69%) (Hypostat, 2014; Hypostat 2011) (see Table 1).

Table1

**Representative Interest rate (annual average based on monthly figures, %) (1) in the
Baltic States, 2000-2013**

| Year | Latvia | Lithuania | Estonia |
|------|--------|-----------|---------|
| 2000 | 11,40 | 10,38 | 9,93 |
| 2001 | 11,10 | 7,72 | 8,77 |
| 2002 | 8,60 | 7,41 | 6,05 |
| 2003 | 8,30 | 5,64 | 4,97 |
| 2004 | 5,00 | 4,47 | 4,52 |
| 2005 | 4,43 | 3,27 | 3,32 |
| 2006 | 4,83 | 4,26 | 4,06 |
| 2007 | 5,99 | 5,53 | 5,40 |
| 2008 | 6,65 | 5,83 | 5,83 |
| 2009 | 4,88 | 3,87 | 4,17 |
| 2010 | 3,88 | 3,50 | 3,70 |
| 2011 | 4,05 | 3,42 | 3,71 |
| 2012 | 3,89 | 2,89 | 2,97 |
| 2013 | 3,28 | 2,62 | 2,39 |

(1) Weighted average interest rate on loans to households for house purchase.

Source: Author's made table by data of Hypostat (2014); Hypostat (2011)

Over the past 10 years, Latvia has undergone significant changes in housing prices. After a rapid increase of price between 2005 and 2007, there followed even more rapid decrease by 2010, by dropping down of housing prices by as much as 50% of their maximum level and even by 70% for apartments in series buildings in Riga, which form an important part of real estate market.

In 2014, in the side of supply there has not been observed large activity. Although the construction costs fell down during the financial crisis, during the last three years they have gradually increased and reached approximately the same nominal level as in 2007. At the same time, housing price index indicates that new housing prices have returned to pre-crisis levels (Central Statistical Bureau data base; Acro real estate company, 2014) (see Figure 2.).

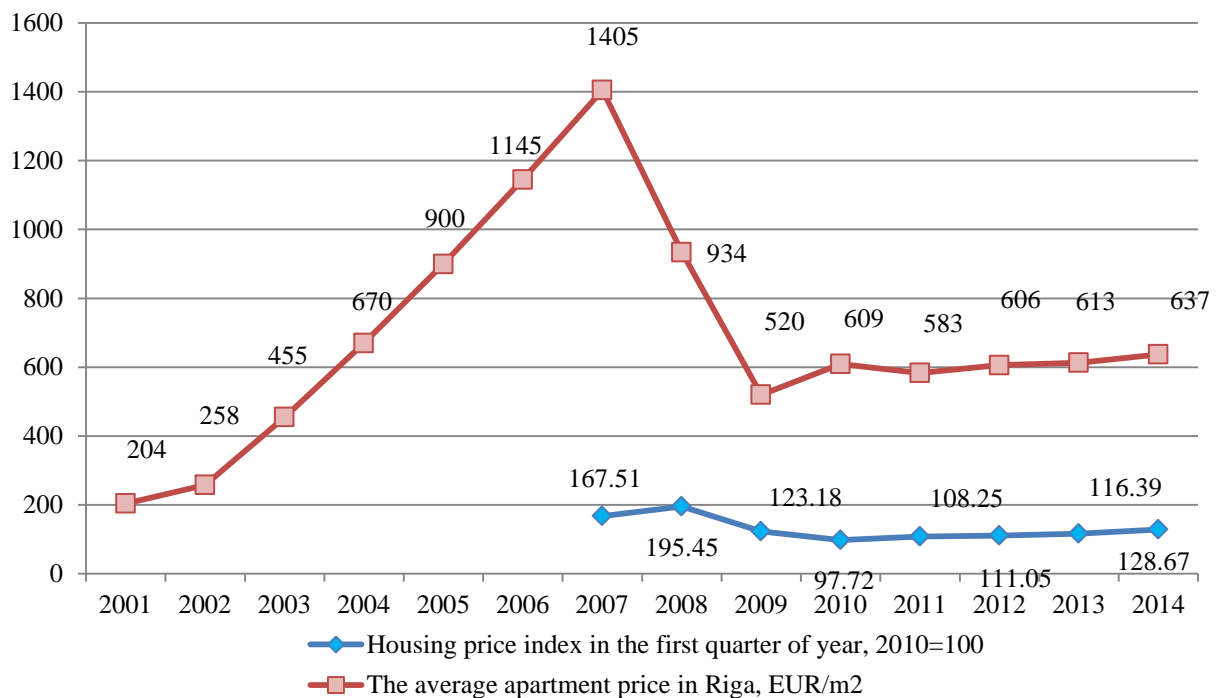


Figure 2. Housing price index in Latvia and average apartment price in Riga

Source: Author's made by data of Central Statistical Bureau and Acro Real Estate company (2014)

In Latvia the mortgage loans are issued by licensed credit institutions (banks) and licensed non-bank crediting companies. Each creditor has its own credit policy and in particular, the requirements which it establishes for the borrower varies greatly. There are 27 banks in Latvia, including ten branches of foreign banks and seventeen banks and most part of them what issue mortgage loans for purchase, construction or repairs of dwelling or houses. Provisions of each bank slightly differ however in general they are similar. The majority of banks offer mortgage loans in amount up to 75% from the market value of immovable property, 25% should be covered by the borrower himself or herself. However there are also banks what offer loans in amount of more than 75% of the value of immovable property, for example, in the amount of 85%. The banks offer mortgage loans with term up to 30 years, issuing them dollars or euros, with both fixed and variable interest rate (The Association of Commercial Banks of Latvia, 2015).

According to the data of Consumer Protection Centre as of November 2014 in Latvia there are operating 13 licensed non-bank crediting companies and their total mortgage loan portfolio constitutes 25.91 million euro (on 06.30.2014). They offer a maximum loan amount of up to 50% of the real estate market value (Consumer Protection Centre, 2014).

Taking into account the above mentioned it should be concluded that the banks generally offer lower interest rates and longer repayment periods. By contrast, non-bank crediting company will be more convenient if the loan is required rapidly.

CONCLUSIONS

The author's concludes the research that:

1. Mortgage lending is long-term lending for purchase, construction or renovation of dwelling or house and it forms the base for housing finance. Mortgage lending system in Latvia was formed in 2012, and it complies with EU requirements. The latest changes in legislation show

that the state more attention devotes to consumers' rights and their protection and thus to ensure their well-being and socio-economic situation in today's society, at the same time imposing also stronger provisions for consumers in mortgage lending, and thus reducing also the risk for banks.

2. The mortgage lending has important role in the case of housing crediting. Development of mortgage lending market during the period after accession to the EU and up to crisis in 2008 has evolved in excessive speed in result of what it resulted in inadequate increase of housing prices, as well as it left negative impact on development of mortgage marked in post-crisis period. Since 2009, the amounts of mortgage lending during post-crisis period have decreased annually.

3. The main instrument in crediting the purchase, construction or renovation of one-apartment and two-apartment houses is a mortgage loan. At the same time, according to the current experience in crediting renovation of multi-apartment houses it should be concluded that crediting for renovation of multi-apartment houses currently is not based on mortgage lending principles. Crediting of multi-apartment houses in Latvia has attracted resources from EU funds and provisions of programmes do not determine pledging the multi-apartment house property, but is based on positive cash flow of the multi-apartment house owners.

4. The requirement for capital investments Latvian banks are interested in use of mortgage market potential, however due to low solvency of residents the inflow of foreign capital in Latvian through special credit lines intended for housing development, as well as through mortgage lending instruments without special state support is severely limited.

Taking into account the above mentioned author's considers some proposals for the government (policy makers) in Latvia:

1. The most important task of the government is to assess the most efficient financing model within framework of new programme of EU funds 2014 – 2020 for multi-apartment building heat insulation.

2. The government has to develop and implement financial mechanisms especially for multi-apartment sector, for example, subsidies, guarantees, forfeiting mechanism, using the experience of other EU countries and combining them with the mortgage loans it would allow to reach significant improvements in the housing sector in the country by providing affordable loans to households for the purchasing, construction and renovation of housing.

Further research by the author in this sector will follow.

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