Mortgage Insurance in Housing Finance—The Way to Go for Countries in Transition

by Andrejus Trofimovas

Lithuania is an Eastern European country, one of the 15 that previously belonged to the Soviet Union, and gained its independence in 1991. Since then, implementation of a market economy has begun in the country. Many other Eastern European countries started a market economy at the same time. Currently, the population of Lithuania is 3.5 million residents. The gross domestic product for the year 2000 was US$111 billion, up 3.9% in recent years.

Private housing in Lithuania, as well as in a majority of other Eastern European countries, has developed in the period of 1990 to 2000. With this development, governments of countries in the region have started looking for solutions to housing finance problems.

The Housing Mortgage Insurance Co. was established in the middle of the year 2000 by the Ministry of Finance of the Republic of Lithuania (Appendix 1). The company insures the housing mortgages provided by the banks and other mortgage lending institutions that have contractual relationships with the company. In case the insurance recipient does not repay the mortgage, the company covers 100% of the unpaid amount of the mortgage. Once the insurance benefit is paid, the company takes over the claim rights on the mortgage recipient's property from the bank and recovers the amount paid as an insurance benefit from the realization of that property.

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In a little more than a year, the company has insured more than 1,200 mortgages. The general insurance portfolio of the company amounts to US$84 million.

In order to achieve a balanced housing market, housing finance in transition economy countries has to overcome certain specific issues that generally have been solved in most of the market economy countries. These issues, or risks to be more precise, could be divided into two groups: Political and Economic.

Political Risks:

- Weak regulation of rights on real estate.
- Inadequate legal acts regulating housing financed by mortgages.
- Macroeconomic risk: governments have no control over the growth of the macroeconomy in the long run. As a result, inflation, unemployment and instability of local currency may occur.

Economic Risks:

- The risk related to property liquidity.
- Insufficient information about the market and potential mortgage recipients.
- Low income of the majority of residents.
- Insufficient funding to meet the demand for long duration mortgage loans.

Reduction of these risks would create conditions to achieve a successful volume of housing finance.

Financial institutions in transition economy countries are forced to develop their activity despite the presence of the risks listed above. As a result, mortgage providers apply all means possible to limit the risks related to their activity. For that reason, most banks operating in transition economy countries set rather harsh requirements for the mortgages they provide, much harsher than those applied by financial institutions operating in market economy countries. A higher initial downpayment, higher interest rates, as well as a shorter mortgage terms are among the stiffer requirements typical of banks in transition economy countries. The interest rates applied to mortgages are based not only on the higher level of risks faced by banks, but also the fact that in most transition economy nations long-term mortgages are financed by short-term liabilities and the mortgage interest rate is set on a different basis from the funding rate.

Furthermore, there is no possibility of assuring the sufficient demand of mortgages, which negatively influences the housing finance market development. The housing conditions standing in such an environment may not satisfy the end user. The problem becomes even more acute because the majority of residents in transition economy countries earn low or average incomes. Even a 30% initial downpayment, which is an amount that could be easily saved by a resident of a market economy country, is usually too high for a resident of a transition economy country as saving opportunities are much more difficult. Also, high mortgage interest rates reduce the numbers of those interested in securing a mortgage.

The improvement of the economic situation of most countries in transition, which is not always rapid but consistent, provides great hope that sooner or later the necessary conditions for financial institutions to provide home mortgages under conditions considered usual in countries with stable economies will be created. Unfortunately, the practice shows that economic development and stability require a number of years to be achieved, while residents will not wait for so long.

While analyzing the current situation in transition economy countries, one conclusion is that an artificial mechanism of guarantees would help eliminate or decrease most housing finance related risks faced by mortgage providers. The elimination of risks for lenders could result in more favorable conditions applied to home mortgages. More favorable conditions would make the housing mortgage more accessible to a larger number of residents. In this way, an artificial mechanism of guarantees would allow access to the conditions of housing finance 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 a guarantee fund.

A natural question arises: Who should take the responsibility of establishing such a mechanism considering the unstable conditions of a transition economy?

Given the magnitude of macroeconomic and political risks, it is easy to come to the conclusion that the establishment of such mechanisms should be initiated by the government. It is additionally supported by other reasons as well:

- 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.
- The state-owned company acting in the developing market has the potential to initiate and offer the underwriting rules and risk assessment norms to mortgage providers and, by doing so, help standardize housing finance.
- The company managed by the government has better access to information about the potential mortgage recipients. Most countries in transition don't have a well functioning information system (e.g.,credit bureau) on mortgage recipients. Furthermore, the necessary databases or credit bureaus may be established on the basis of information managed by a mortgage insurance company as well as other information more easily accessed by a state institution in comparison to private companies.
- Most markets in transition economy countries, as compared to Western countries, are small-scale. This might mean that creation of a private structure may have no basis because of 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. With a small-scale primary market, such investment may be not economic.

What are the possible functional results of a mortgage insurance system in transition countries?

The current practice and the principles of activity of a mortgage insurance company provide that the final desired result is the appearance of mortgages accessible to a larger number of residents in comparison to the situation without a guarantee mechanism. This result is achievable due to banks receiving necessary guarantees of money return.

If housing finance risks can be reduced, one of the major controls on mortgages currently applied, which is the initial downpayment, may be decreased. In general practice, banks without additional guarantees may efficiently function only in the set risk scale (for example, a maximum loan-to-value ratio of 70%). Nations with economies in transition face the situation of higher instability, so property values may also fluctuate significantly. This means that banks striving to avoid the risk of loss on property disposition would request a higher initial downpayment from a potential mortgage recipient. Having the additional safeguard from these risks through insurance, the banks have an opportunity to decrease downpayment requirement.

The second important result achieved is the decrease in the mortgage interest rate. In the situation when the mortgage issued is insured, the bank has less need of covering risks with the mortgage interest rate. Furthermore, the premium paid by the insurance company may also cover the costs related to losses not covered by property recovery. Having the opportunity of insuring the mortgages issued, and in this way eliminating most risks, banks are interested in obtaining insurance on the majority of mortgages issued. In such situations, interest rate discounts may be applied for such mortgages.

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

The efficiency of housing mortgage insurance activity in transition countries can be demonstrated by the experience in the field in Lithuania.

Due to efforts in the field of housing finance applied one and a half years ago to establish the housing insurance company, the required initial downpayment that the mortgage recipient had to save has dropped to 5% from 30% previously. It is important to underline that in most Eastern European nations (those neighboring Lithuania as well), the initial downpayment remains as high as 30%. Other mortgage conditions have improved as well.

Furthermore, the possibility to fully transfer the related risks to the mortgage insurance company has helped to increase competition among the banks, as housing mortgages have become an attractive product. A year and a half ago, the interest rate in the banks for mortgages provided in U.S. dollars exceeded 11% per year. Now, in cases when mortgages are insured, the banks provide mortgages for less than 6% annual interest rate. Banks have become more interested in having as many mortgages as possible insured, thus apply a 1 percentage point interest discount for insured mortgages.

Most banks either do not apply the charge for mortgage prepayments or have significantly reduced it.

Mortgage insurance has efficiently addressed many housing finance related issues and it can be an effective cure for other problems faced by most countries in transition.

Due to mortgage insurance, the country's consumption level may increase. Some transition countries, to this day, face a problem of residents feeling insecure about the future and thus decreasing their consumption. A possibility to obtain housing with a minimal initial downpayment allows the prospective homeowner to buy a home sooner rather than postpone the purchase while saving up the downpayment. As housing is one of the largest purchases most residents make, it stimulates the economy.

With a given initial downpayment, a person taking mortgage insurance has an opportunity to increase the amount of mortgage loan received. In this way, the buyer has an opportunity to obtain more expensive and better housing. In Lithuania, as well as other transition economy countries, new housing costs more than old. The statistics show that the mortgage insurance is especially popular among residents obtaining new housing.

The higher number of newly developed housing units, which appears once a mortgage insurance company starts functioning, increases the scale of housing construction, which is very acute for countries in transition. It becomes even more acute knowing that very low levels of housing production have existed for a long time in Eastern European countries[1]. For example, across the region housing production in 1999 was less than 40% of its 1990 level. Moreover, one-third of the countries are producing less than 20% of the 1990 level, and by 1999 none had reached its 1990 level.

The increase of housing construction scale solves other economic problems.

Based on various calculations, one job opening created in the field of construction creates a number of other job openings in other fields of the economy. It is believed that the multiplier of new jobs is most effective in the field of construction. The gross domestic product is stimulated through the development of new jobs. It becomes even more important when taking into consideration the fact that the gross domestic product per capita in most transition countries is much smaller than that of market economy countries.

As previously mentioned, mortgage insurance increases the homebuyer's potential of receiving a rather large mortgage and of purchasing a better, more modern house with more efficient construction and systems. This means that the majority of residents' income could be used not for paying various utilities but for satisfying other needs. This positively influences consumption internally and allows the more rapid growth of local industry and service sector.

Mortgage insurance, by its nature, is oriented to young and low-income families. Usually young families cannot obtain housing due to requirement of high initial downpayments. As the income of young families in transition economy nations is considered rather low and the time frame for saving up for initial downpayment is long, housing mortgage insurance becomes almost the one and only means for obtaining housing. Before the mortgage insurance company started functioning in Lithuania, the average age of a mortgage recipient was 34 years old. Now it has become closer to 30 years old.

Mortgage insurance in transition 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 built a number of years ago that do not conform even to minimal energy saving and safety requirements. People with low and average income do not have an opportunity to improve the situation and renovate their apartments. This situation cannot be solved by the government, which has limited resources. The way to improve the housing is provided with the help of bank mortgages. But legal acts of most transition economy countries do not assure banks with timely return of such mortgage investments.

The major unsolved problem is related to pledged property and the guarantees necessary for mortgages. As a result of this situation, the absence of a pledged property in such projects discourages banks from financing the renovation of apartment blocks. The problem of insufficient guarantees may be solved with the help of guarantees provided by the mortgage insurance company.

Mortgage insurance may be successfully used in solving problems related to housing and social problems of the elderly. The solution to such problems may be the reverse mortgage system applied in some Western countries. Receiving money by mortgaging the housing they own, the elderly get an opportunity to renovate their housing and have more money for their other needs. An acute problem exists in most transition economy countries where the pension age residents have the least social guarantees. Banks in transition economy countries usually avoid analyzing such projects due to high possible risks. Mortgage insurance could provide necessary guarantees for implementation of a reverse mortgage program.

As mentioned earlier, a very acute problem that institutions providing housing mortgages in transition economy countries face is the lack of long-term financial sources for long-term housing finance schemes. Mortgage insurance might be considered in a search for alternative financial sources for home mortgages. The mortgage insurance company might participate in mortgage mobilization allowing for mortgage bonds or mortgage-backed securities (MBS). Other countries characterized by growing mortgage markets are more actively looking for alternative methods of funding of mortgage loans. In cases when the market of deposits is insufficient for financing long-term home mortgages, the stock of mortgages already issued might stand as a solution to the problem. Securities such as 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 capitalization basis. In transition economy countries, it could be successfully achieved by a pool of insured mortgages offered through an MBS issued by a mortgage insurance company. Participation in MBS schemes is one of the strategic aims of mortgage insurance companies.

In conclusion, there are a number of possibilities for applying the mortgage insurance mechanism as a major means of helping to successfully develop a housing finance market in transition economy countries. Mortgage insurance is one of the most successful instruments to efficiently stimulate the growth of financing of housing markets in developed nations and in transition economy countries.

NOTES

[1] Robert Buckley, "Housing Finance in Transition Economies: Its Role in Poverty Alleviation and Private Sector Development," presentation at the International Conference in Vilnius, October 18, 2001.

APPENDIX: 1.
THE HOUSING MORTGAGE INSURANCE COMPANY OF LITHUANIA

The Housing Mortgage Insurance Company is an insurance company established by the government of the Republic of Lithuania, which insures loans intended for purchase, construction and reconstruction of houses or apartments. The company insures the loans for construction, purchase or reconstruction of housing granted by the banks or other credit unions registered in the Republic of Lithuania, which have signed cooperation agreements with the company.

The Ministry of Finance of the Republic of Lithuania is the founder of the company and is the only shareholder. Currently, the authorized capital of the company amounts to 17 million Litas (US$4.25 million).

The company's objective is to provide mortgage insurance and at the same time to more effectively resolve the problems related to providing the residents of the Republic of Lithuania with housing, while obtaining the maximum profit from this activity. The first insurance was signed in July 2000.

The insured housing loans have several essential advantages over the uninsured ones. First, once the loan is insured, it is sufficient for the recipient of the loan to have the initial contribution equal to 5% (without mortgage insurance banks in Lithuania usually request a 30% downpayment). Besides, the majority of banks give an interest rate discount of up to 1 percentage point of the insured loan.

Other banks grant additional privileges to those recipients of insured housing loans who recover the loan prior to the term established in the loan contract. That is, no taxes are claimed once the loan is recovered prior to the established term. At present, the company has cooperation agreements signed with five major banks of Lithuania: Vilnius Bank, agricultural bank of Lithuania; public company bank "Hansabankas;" Savings Bank of Lithuania, "Snoras" Bank; public company bank "Sampo-bank," and "Nordea" Bank.

According to the housing loan insurance contract, the recipient of the loan shall be the insured—a citizen of the Republic of Lithuania who, on the expiration date of the loan contract, is not older than 65 years and who meets other requirements specified by the company and the bank. According to the housing loan insurance contract, the bank granting the housing loan should be registered in the Republic of Lithuania and have a signed cooperation agreement with the company, and thus becomes the covered.

The insured housing loan cannot exceed 95% of the housing value purchased or mortgaged. That is, the recipient of the loan must have the initial contribution amounting to at least 5% of the dwelling value purchased. Moreover, the loan applying for insurance cannot exceed US$100,000. The insured must mortgage the real estate purchased, under construction or undergoing reconstruction for the means of the loan to the bank.

Furthermore, the insured must insure his/her life for the period of the loan by the amount no less than the portion of the loan that has not been recovered in cases when the loan is given for longer than a 10-year period, or the insured becomes older than 45 years by the end of the insurance agreement. The property, purchased, under construction or undergoing reconstruction for the means of the loan, must be insured for the period of loan validity for the value no less than the market value determined by a licensed appraiser. However, the amount insured, should be no less than the portion of the loan not yet recovered.

By the means of the housing loan insurance contract, the Housing Mortgage Insurance Company shall ensure 100% repayment of the housing loan. In case the recipient of the loan fails to recover the housing loan or a portion of it, according to certain terms established under the insurance contract, the bank cancels the housing loan contract and appeals to the insurance company for the insurance benefit. After the company pays the insurance benefit, the bank transfers all of its claim-related rights toward the recipient of the loan, including the rights toward the property mortgaged to the company. The company meets its requirements from the amount recovered within the limits of the insurance benefit, and transfers the remaining amount to the bank. The latter covers interest, fines, forfeit, and sanctions that the recipient of the loan failed to pay and that do not constitute the object of the housing loan insurance contract.

The housing loan insurance premium rates of tariffs are set between 2.77% and 7.78% of the amount insured, and the exact amount depends on the amount of the mortgage downpayment. The insurance premium could be paid all at once, or can be loaned alongside the loan for housing. In this case, the insurance premium can be paid during the entire duration of the loan agreement. A majority of the recipients for the loan insurance pay only a portion of the total amount. The other portion is covered by the State. This happens due to the fact that half of insurance premiums granted to the citizens are entitled to the State support in the area of housing provision and is paid by the funds of the State. For instance, Lithuania supports those who reside in apartments of insufficient living space, or those who haven't had any housing property for more than five years.

The company started its activity in the end of July 2000 and is successfully carrying out its objectives. The total insurance portfolio of the company by the end of this year may exceed US$30 million.

Along with the activity of housing mortgage insurance, the company actively operates in other housing mortgage insurance related activities. The Housing Mortgage Insurance Company constantly observes and analyzes the market of Lithuanian housing loans. The specialists of the company actively participate in the creation of new housing insurance products as well as improvement of the existing ones. On the basis of present information of the company, a number of articles in periodic press and several scientific studies were written. The company also participates in drafting laws of the Republic of Lithuania that relate to the regulation of the housing policy in the country.

The Housing Mortgage Insurance Company became a member of one of the world's largest housing finance associations, the International Union for Housing Finance, on April 30 of 2001.