A Rising Star: The National Mortgage Insurance Corporation of Serbia – Nacionalna korporacija za osiguranje stambenih kredita (NKOSK)

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The purpose of the article is to provide a case study on NKOSK and how it was used as a catalyst to launch mortgage lending in Serbia.

Objectives of the Corporation

In 2002, after years of economic and political turmoil, the Government of Serbia and the National Bank of Serbia (NBS) were looking for mechanisms to stimulate economic reform and development. There was serious concern with the state of the underdeveloped and neglected housing and financial sectors.

At the time, conditions were not favourable to the development of a functional private mortgage market in Serbia. Existing taxation of housing and registration were significant impediments to the growth of that market that could deprive Serbia of the economic benefits that would arise from increased homebuilding activities. Likewise, legal practices surrounding the insufficient protection of lenders' rights were preventing the growth of the mortgage market. Before the enactment of the Mortgage Law, in 2006, the courts had exclusive jurisdiction over enforcement of the mortgages, which meant that the lender could not assess the amount of time needed for the enforcement in case of a default (there are reports that some of enforcement cases took more than 5 years).

In response, the Government decided to create the National Mortgage Insurance Corporation of Serbia (NKOSK):[1] a publicly-owned corporation mandated to develop the private mortgage market in Serbia by offering targeted financial products to address critical market needs. Through its financial activities, NKOSK was to promote improvements to the housing and financial sectors. Initially, NKOSK's products would be in the form of mortgage insurance and at later stages it would explore liquidity funding and possibly other intermediary services.

NKOSK was considered a catalyst with which the necessary economic, legal and regulatory reforms could be addressed. For developing markets such as Serbia, governments do not have the luxury of time to complete all the needed reforms before demonstrating tangible results for Serbian families.

The goals of this corporation were to:

- Encourage banks to lend mortgage funds to qualified borrowers;

[1] CMHC was originally retained by the Central Bank of Yugoslavia to develop the business concept and plan. CMHC continues to assist with the implementation of NKOSK through the generous contributions of the Canadian International Development Agency (CIDA) and the World University Services of Canada (WUSC)

Development of a Housing Finance Sector

I. Enabling Environment	II. Housing System Foundations	III. Active Housing and Mortgage Market
1. Macroecon. Environment	1. Building & Land Use Regulation	1. Supply of Affordable Housing for Sale
2. Political Environment	2. Financial Regulation of Potential Mortgage Lenders	2. Supply of Funds for Housing Finance & Experienced Mortgage Lenders
3. International Investment	3. Legal Infrastructure for Mortgage Lending	3. Information to Support Housing Finance Transactions
4. Govt. Priority for Housing		
5. Social Safety Net		
6. Consumer Demand & Confidence		

- Test the components of the housing finance system and promote improvements and standardization;
- Promote access to housing finance choices for consumers;
- Promote lower interest rates and other transactional costs;
- Pave the way for future mortgage funding instruments secured by high quality real estate assets.

State of the Market

Developing a housing finance sector requires an enabling environment created by government, appropriate legal and financial infrastructure and an active housing and mortgage market. The chart above summarizes the framework for the assessment that was undertaken to develop NKOSK. This article will focus on some of the key findings.

Consumer Demand and Confidence

The preferred time to introduce mortgage financing and mortgage insurance is at the beginning of a period of sustained economic growth. At the time of NKOSK's introduction, Serbia had achieved major gains in economic restructuring in a short period of time. Inflation had been reduced to an estimated 15% for 2002 from 40% in 2001 and NBS had restructured the banking system, removing many licenses and restoring integrity to the system. The Yugoslav Dinar YUD/€ exchange rate had been stable since year 2000. The rapid pace of reform was continuing with support from international financial institutions (IFIs). Unemployment remained close to 30%.

Challenges in Mortgage and Housing Environment

Shortage of Affordable Housing: Especially in larger urban centres, there was a shortage of housing due to:

- Lack of access and affordability for young adults
- Shortage of serviced land for development
- Poor reputation of the local construction industry

Housing Finance Challenges:

- Short-term deposits created funding mismatches for banks
- Bank capitalization was low
- Banks had limited consumer credit experience
- High fees and taxes (up to 8.5% of house price) were an impediment to mortgage lending

- 80% of population was outside of the banking system
- Dinar-denominated loans were relatively non-existent and most banking activities, including personal savings, were conducted in Euros and to a much lesser degree in Swiss francs
- Since many of the banks operating in Serbia were European, liquidity was not a significant issue
- There was limited credit information on borrowers
- Income and expense statistics were unreliable; wages were often in cash

Lender Attitudes to Mortgages:

In that environment, banks looked to the government for direction in developing the market. Banks wanted registered properties and assurance so that they could successfully repossess defaulted properties in a reasonable time frame. Banks saw mortgages as valuable assets for their balance sheets and as a cross-selling opportunity for other consumer products.

Consumer Attitudes to Mortgages:

Up to 2001, no functioning mortgage or real estate market existed in Serbia. Under the previous socialist system, people used to receive real estate as a gift from their employer (typically a state-owned company) after several years of employment or work experience. A mortgage or loan was treated as a gift because at that time inflation was very high. It was a challenge to change people's understanding of what a mortgage loan was.

As a result, it was very important to develop a public awareness of the need to create a functioning real estate and mortgage market, as well as to develop a public awareness of how to buy real estate under the new system. Real estate would no longer be provided for free.

A September 2002 survey of potential mortgage borrowers was conducted in Belgrade, Novi Sad and Nis. The dominant characteristics of respondents were:

- Young, well educated, married and working in management positions or as highly qualified intellectuals; average household incomes €600-800; positive views on economic growth.
- 40% lived with parents, 35% in apartments that did not meet needs; 22% were renting.
- 69% of respondents wanted a favorable loan so they could purchase an apartment; majority also wanted other loans or credit cards.
- Majority were looking for loans from €20,000 to €30,000 with monthly payments of €200-300 respectively.
- Respondents were willing to have employers act as guarantors of repayment or endorsers.
- Concern with high interest rates.

Legal System:

Two existing laws and current practices met, to some extent, legal conditions that are required for mortgage lending; namely, that housing purchasers are able to establish a valid property title, and that a lender can register a claim against a property for the provision of a loan and enforce their registered claim. However, legal challenges that remained were:

- Three different registry systems[2]; and incomplete registries, especially in the south
- Testing the new mortgage law when it came to enforcing creditors' registered claims against a property where a mortgage borrower had defaulted

Regulatory Issues:

- NBS' policy of tightening the banking sector; restricting the number of banking licences for a period of time
- Capital requirements were brought in line with Basel standards
- There were no specific regulations for mortgage lending in terms of provisions or recognition for mortgage insurance.

However, regulators accepted that specific regulations were required for mortgage lending and mortgage insurance to reflect international approaches and to ensure the safety and soundness of the system.

Recently, minimum reserve requirements for foreign borrowing were implemented to dampen overall lending growth. Higher than expected inflation in Serbia had been attributed to this growth in lending,

Strategy to Address Deficiencies in the Market

Stakeholders in the Serbian mortgage market realized that the needed reforms could not happen overnight; in fact it would likely take many years to overcome the decades of neglect. The political environment was not stable and the government needed to demonstrate a tangible result to Serbians. From a theoretical point of view, one would wait until all of the legal, regulatory and other preconditions were in place before starting to develop housing finance institutions.

But were there other options? Could the government wait years for the legal and regulatory reforms to take place? This would result in even greater housing deficiencies and still there would be no experience with mortgage lending.

[2] Depending on the part of the country, the title registrations are managed by three different bodies-land registry court, cadastar and courts of general jurisdiction. However, the process of uniting the land registry has been under way for several years now, and is expected to be completed in several. The cadastar is taking over the data and is working on the computer system of registration for the entire country.

Moreover, given the small market size for mortgages in Serbia, it was logical to rely on the existing banks, rather than create another lending institution such as a specialized mortgage bank. Mortgage insurance, which specialises in managing credit risk, was intended to contribute to a systemic approach to developing the banking and financial sectors. This represented a strategic opportunity to boost the housing sector and strengthen the balance sheet of the existing banks.

The decision was taken that Serbia could not wait until all the typical preconditions were in place before starting the development of a new institution. It was also clear that a private institution would not start any mortgage operations under such conditions and that the government would need to be the catalyst. The strategy called for a concurrent plan of launching a new company that would take on the credit risk while at the same time addressing the preconditions through a number of mechanisms including legal reforms and negotiated agreements with banks.

The new company would be the National Mortgage Insurance Corporation of Serbia (NKOSK). This corporation would be taking on not just mortgage credit risk, but also the uncertainty of launching mortgage lending in an uncertain market where there were many questions regarding title, enforcement, not to mention economic and political instability. The company structure and product design would play a big role in how these risks were managed and controlled.

The People

As with any successful business venture, the people and expertise behind the initiative were critical. For Serbia, this began with the current Minister of Finance, Minister Dinkiç. At the start of the project, he had been the governor of the Central Bank of Yugoslavia. Realizing the need for housing and housing finance after years of neglect, Governor Dinkiç created a team to look at possible strategies, models and options to initiate mortgage lending. The team included expatriate businessmen as well as local experts and analysts.

The team considered a number of European and North American mechanisms before retaining the services of the Canada Mortgage and Housing Corporation (CMHC). CMHC was selected for a number of reasons, including their success in Canada working with private lenders and their growing success internationally adapting mortgage insurance and liquidity financing instruments to new markets. CMHC assisted the Serbian team in developing the business concept and planning for NKOSK and they continue to assist with the implementation of the corporation.

The Serbian team's objectives were multiple:

- Leverage the resources of the growing number of foreign lenders entering the market
- Deliver tangible results to Serbians quickly
- Concurrently address the myriad legal, regulatory and infrastructure deficiencies
- Build a credible housing finance system that both business and consumers could have confidence in

To meet these objectives, the Serbian project team needed to work closely with banks and government agencies as well as draw on the technical and managerial expertise of CMHC. Notwithstanding these efforts, the active participation of the Minister of Finance was critical; first to ensure the political support needed for the legislative and regulatory changes.

Corporate Structure

The corporation was established to be a commercial shareholding company. It was initially founded with one shareholder, the government of Serbia. Ultimately, the private sector will be invited to participate. The decision to invite private sector investors remains the decision of the Government and may still be a few years away. Nonetheless, NKOSK is currently seeking strategic partners.

While its initial mandate was to promote the development of the mortgage market, its long term goal is to be a viable commercial company. It is this emphasis on commercial viability that is to keep NKOSK focused on commercial discipline. To emphasise this, the initial management team and staff were hired from the private sector.

NKOSK is regulated and established by a specific law on NKOSK. Insurance reserves and a 16:1 risk capital ratio are currently regulated by the law for NKOSK.

Product Design

The product was a key element of the strategy as NKOSK did not want to take on all of the risk itself. Since there appeared to good potential demand and lenders were eager to enter into mortgage lending in Serbia, NKOSK wanted to share the risk with banks in a fair and equitable manner. The question remained however: how much risk did NKOSK need to assume in order to encourage banks to enter the market and to offer borrowers access to affordable mortgage terms?. NKOSK also needed to deal with the lack of mortgage insurance regulations that would prevent adverse selection by banks.

Just after the formation of NKOSK, negotiations with respective banks operating in Serbia were begun. The product was presented to the banks and modified to include their feedback. The objective of all was to ensure the security of the banks' mortgage portfolio and ensure the viability of NKOSK's mortgage insurance fund.

A balance was struck: NKOSK covers 75% of the net loss that may be incurred as a result of default and ultimate foreclosure. The maximum loan to value ratio is set at 80%. Banks sign a contract with NKOSK stipulating that they will submit all mortgage loan applications that fall within a specific category to NKOSK for approval or rejection. If rejected, the bank has the option to issue the loan without NKOSK insurance. If approved, the loan will be insured.

Business Volumes
January 2005 – May 2006

Distribution of Insured Bank Lending by Loan Size			
Euros Number of (000s)	**Percentage Loans**	**Distribution**	**Average LTV**
0-25	1,322	49.9%	58%
25-50	891	33.6%	62%
50-75	271	10.2%	67%
75-100	94	3.5%	67%
100-125	36	1.4%	69%
125-150	16	0.6%	60%
150-175	5	0.2%	71%
175 +	15	0.6%	27%
Total	**2,650**	**100%**	**61%**

Source: NKOSK

Distribution of Insured Bank Lending by Loan To Value		
LTV	**Number of Loans**	**Percentage Distribution**
0-50%	690	26%
50-60%	357	14%
60-70%	868	33%
70-80%	735	28%
Total	**2,650**	**100%**

Source: NKOSK

NKOSK is promoting a standardized approach to mortgage origination. Standards such as those promoted by the EBRD serve as a model for NKOSK. However, because of the developing nature of the Serbian mortgage market, NKOSK must be more flexible in its approach to standardization. For example, NKOSK does not require borrowers to have life insurance because it is currently very expensive.

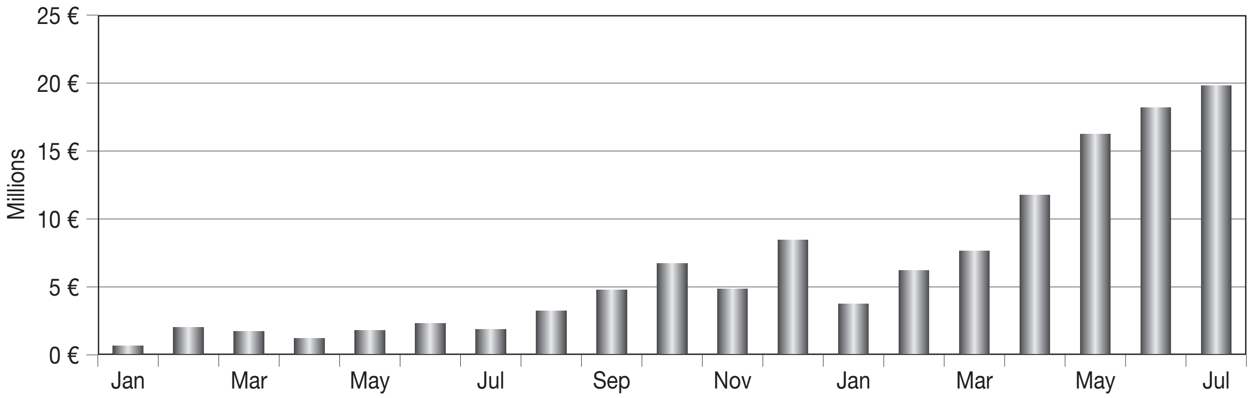
It should be noted that this product does not cover the first tier or layer of risk similar to American mortgage insurance. Rather, this product covers a portion of the net loss. There is still a strong incentive for banks to prevent or minimise losses since they are still exposed to 25% of the net loss. Banks are also responsible for pursuing default management and if necessary, foreclosure. The onus of ensuring that the foreclosure process works remains on the government. To a large degree, the risks faced by the Serbian government are similar to foreclosure risk in other countries. The Serbian government also faces the additional risks related to economic transition and the public sector employment transition. As one mitigation, unless the banks follow closely the foreclosure procedure prescribed by the Mortgage Law and the additional notifications prescribed by NKOSK, the banks risk loosing the insurance.

Other Incentives

The introduction of mortgage insurance offered an incentive to lenders in terms of reducing the credit risk. Like other markets, this risk reduction also contributes to the overall safety and soundness of the banking system. As such, banks enjoy additional regulatory privileges for using mortgage insurance. These include reduced capital and provisioning requirements for mortgage loans that are insured by NKOSK. The risk weight and the provision requirements for delinquent loans on insured mortgages are set at 0% to reflect the backing of the government-owned company.

The product and the initial regulatory incentives were successful at getting some banks to sign on. While this achieved some of NKOSK's objectives, in the first months of NKOSK's existence, the volumes and level of competition were lower than desired. The government then decided to introduce a co-lending program to be used

Value of Insured Mortgages per Month 2006-06



Source: NKOSK

in tandem with mortgage insurance. The program was designed by NKOSK and submitted for government approval.

Under the co-lending program, the borrower's down payment would be reduced to 10% and the government would provide a 20% loan. The bank would then provide a loan for the remaining 70%. For the first 20 years or until the bank's portion of the loan is paid off, no interest would accrue on the portion of the loan provided by the government. Interest of 0.1% would be paid to the government on the last 5 years of repayment. For lenders, one additional requirement was a maximum interest rate of 6.95% on bank loans which were combined with a government co-loan.

This product generated a significant increase in demand by reducing the down payment as well as the monthly instalments for borrowers. It also created the conditions where more and more lenders joined onto the mortgage insurance program as well as the co-lending program. Lenders actively competed for business – both for the co-lending program as well as for regular insured loans. While the co-lending program proved to be a strong stimulus to the market, it accounted for only less than 8% of total lending (the total of co-lending and insured lending) as not all borrowers used the program and subsidy would only be for up to 20% of the property value.

Results

So was this a fanciful experiment doomed to failure or did it achieve results? In October 2004, NKOSK was incorporated as a commercial company wholly owned by the government. It began operations in January 2005.

Impact on Market

As more and more banks signed onto the NKOSK program, competition increased and mortgage interest rates fell. When NKOSK began business, interest rates were around 12% on Euro-denominated loans. By the end of the first year, they had fallen to around 7%. The effective interest rates were lower still if bank loans were combined with a government co-loan program. While rising competition among banks contributed to lower interest rates, the greatest impact was seen after the implementation of the co-lending program.

By the end of the first year of NKOSK, over 1,500 loans had been approved for insurance with a lending value of over 40 million Euros. This rose to over 2,600 loans and over 75 million Euros by mid-May 2006 (after 16 months of operation). The average loan size and loan to value ratio have remained fairly low. The primary purpose of mortgages has been for the purchase of existing housing units. This will start to change soon as a new law permitting mortgages for the construction of new homes is implemented.

NKOSK has been successful at targeting modest housing. The vast majority, over 80%, of the lending has been for loans under €50,000. Additionally, the risk level has been relatively low as the averagee loan-to-value ratio has been around 60%.

NKOSK has experienced fairly steady growth, particularly since the start of 2006. January and February 2006 volumes were lower than the latter months of 2005, but this is related to seasonal factors including the Christmas season.

It is important to emphasise that a few months after the start of the mortgage insurance program, NKOSK successfully designed and implemented the co-lending program.

Lender Clients

The banks that use NKOSK's mortgage insurance reinforce the success of the story and speak of the confidence in the government's strategy. Key clients include institutions from Austria such as Raiffeisen Bank, HVB Bank, Hypo Bank and Erste Bank; and institutions from Greece such as EFG Bank. The list also includes Pro Credit Bank, an institution sponsored by the International Finance Corporation (IFC). At this time, there are thirteen banks in all who have signed on with NKOSK and with the exception of one they are all from EU countries.

New Law

In February 2006, the Government of Serbia approved a new mortgage law that achieved three key things:

- It established a clear administrative process for foreclosure with specific timeframes to be followed.
- It allowed for all property transactions to be registered at only one location, the cadastre, rather than several.
- It allowed for mortgages liens to be placed on homes under construction.

Other Market Improvements

In addition to the mortgage insurance company, Serbian stakeholders worked actively during this time to create a credit bureau. The National Bank of Serbia (NBS) and the Banker Association created a Credit Information Bureau which greatly improved the scope and reliability of credit information. The banks offered their support for this initiative. A new credit bureau was launched in 2004, and all 49 banks now operating in Serbia have signed contracts with this institution.

Conclusion

Starting a mortgage insurance company in any market is not without significant risks. What the NKOSK experience demonstrates is that in developing markets like Serbia, governments can develop pragmatic strategies that deliver results quickly while at the same time addressing the market risks and challenges. These strategies do require sober thought and require realistic tactics. It also requires governments to work closely with the private sector, to draw on international experience, and to stay focused on addressing legal and infrastructure deficiencies.

The story is not over and there remain a number of key challenges to address in Serbia. The new law is untested, further regulatory work is required, professional services such as property appraisers are under-developed, and the mortgage culture is still in nascent stages.

Still, a recent survey in Belgrade just emphasises the impact the government's strategy has had. In this survey of young Belgradians, they were asked what the best thing about living in Belgrade was. NKOSK was listed third – after beautiful women and night life. Who would have thought that mortgage lending could keep such company!