DEVELOPING SECONDARY MORTGAGE MARKETS IN SOUTHEAST EUROPE

ASSESSMENT OF THE MORTGAGE MARKETS IN ROMANIA

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ASSESSMENT OF THE ROMANIAN MORTGAGE MARKET

EXECUTIVE SUMMARY

Romania has been working steadily over the past three years to bring about the macro-economic, financial, and legal changes necessary to support a vibrant mortgage market. As conditions improve, Romania's major banks are becoming increasingly interested in expanding consumer lending, including housing lending.

The legal framework for mortgage lending has undergone substantial reform; mortgage loans can be made under both the Mortgage and Banking Laws. Major improvements have been made in the foreclosure process, including elimination of the necessity of court procedures prior to foreclosure. The law seems generally adequate to support an active primary market. The Mortgage Law also provides a rudimentary framework for issuance of mortgage bonds or mortgage-backed securities, although most experts consider the current law and regulations to be inadequate to support a strong secondary market.

The macro-economic climate is also improving. GDP growth has been positive since 2000, and inflation has fallen from 40.6 percent in 2000 to an estimated 22 percent in 2002. Privatization of the banking sector has made major progress, although it is recent and it is not yet complete. While the positive impact of foreign ownership on the banking sector overall still has some way to go, those banks most interested in mortgage lending have benefited significantly from both foreign investment and expertise.

Nevertheless, conditions are not yet optimal for development of either the mortgage market or the domestic debt market. Interest rates remain too high to encourage substantial demand for long-term loans. Government debt issuance is largely offshore, and the Government's longest local currency notes are two-year maturities. The latest government bills were issued at nominal rates of over 20 percent, down from recent pricing but still quite high. Finally**,** there is currently limited effective demand among domestic investors for non-government fixed income products, including mortgage-backed debt instruments. Reform of the pension system is still pending, and the principal market would thus be the banks.

1.0 OVERVIEW OF THE PRIMARY MORTGAGE MARKET

1.1 Overview of the Banking Sector and Economic Environment

Romania is in its third year of recovery from the severe economic crisis suffered during the mid-1990s. The economy declined steeply in real terms from 1997 to 1999, and inflation reached 155 percent in 1997. In marked contrast, real GDP increased by over 4.0 percent a year in 2001 and 2002, unemployment has fallen to single digits, and depreciation of the currency has slowed. Major progress has been made in privatization and restructuring of Romania's banks. Controlling stakes in several of the largest banks have recently been sold to strategic investors from Greece, Austria, and France, and many of Romania's banks are now liquid and well capitalized.

As noted, however, the economic environment is not yet fully conducive to sustained development of consumer and mortgage lending. Although economic conditions have improved in the last few years, the pace of change has not been as rapid as had been hoped for. Inflation remains high—over 20 percent. Although this is an improvement from previous levels and is expected to continue to decline, prevailing interest rates make long-term borrowing prohibitively expensive for the vast majority of households, especially for the long-term lending necessary to support housing purchases. Interest rates are not only high, but—also equally damaging—they have been volatile; high levels of uncertainty disrupt economic activity, especially for credit. Even if banks are somewhat protected from interest rate risk through variable rate products, borrower ability to pay suffers in the face of abrupt changes in scheduled amounts due. Finally, the housing market itself is constrained by lack of construction financing, limited availability of land, and an exceptional amount of administrative burden in the acquisition and construction process.[1]

Bank privatization is not yet complete; the assets of two of the largest state owned banks have been moved into a special holding entity for restructuring and liquidation. Romania's largest bank, BCR (Banka Comerciala Romana), with 31 percent of banking assets, remains in Government hands despite recent efforts to complete a trade sale. BCR is the biggest bank and biggest mortgage lender in Romania, and the third biggest bank in the Central and Eastern European region. Thus, more restructuring of the banking sector lies ahead.

It is important to note, however, that among the banks most aggressively pursuing mortgage finance, significant foreign investment and expertise are being brought to bear. Thus, Alpha Bank, HVB, and Ro-Fin, the mortgage bank being established by the Romanian American Enterprise Fund (RAEF), represent the new face of housing lending. BCR, with the major share of the mortgage portfolio, has also launched a major new mortgage finance initiative and has the advantage of its large client base and branch network.

Large increases in lending have yet to occur. Like other banks in the region, total loans in the Romanian banking system (at approximately $3 billion) represent a minority of bank assets ($9.5 billion). As one analyst recently put it, "the volatility of the economy, uncertainties over the predictability of the ROL (Romanian lei)/dollar exchange rate, as well as high interest rates, have been major obstacles that banks face in their attempts to increase long-term loans for individuals." In this situation, banks do not take long-term risks, and clients cannot predict how interest rates might fluctuate in the future," said a manager at one foreign-owned bank.

1.2 Overview of Consumer and Mortgage Lending

There is growing interest among major banks in developing the mortgage market, but mortgage lending is just now coming of age in Romania, and the total portfolio is small. Some banks expect the consumer loan market to bloom first, which would be expected, given the high interest rates. Nevertheless, there is reason for optimism. Banks feel that there is large pent-up demand for single-family homes, for example, and the desire for home ownership is a strong cultural characteristic. A number of banks in Romania are actively planning for an expansion of their mortgage lending, including, BCR, HVB, Alpha Bank, Raiffeisen, and Ro-Fin. In addition, the National Housing Agency (ANL), which acts primarily as a

[1] See Sally Merrill, Harold Katsura, and Carol Rabenhorst, "The Prospects for Housing Finance in Romania, The Urban Institute, December 1999, Washington, DC.

housing development and construction agency, provides subsidized loans to eligible borrowers through BCR.

The total mortgage portfolio was approximately $90 to $100 million at the end of 2002. BCR, which launched its new mortgage program toward the end 2001, had a portfolio of $60 million in real estate loans by October 2002, and expected this to increase to $80 million by the end of December 2002. Alpha Bank's mortgage portfolio is roughly $20 million, and ANL's loans total about $13 million. HVB, which has been offering mortgage loans only for a few months, has a portfolio of about $1.5 million; Ro-Fin, which is also in a start-up phase, had loans outstanding of just over $1 million in October 2002. Raiffeissen is just beginning is mortgage lending activity.

Donors and international development agencies have continued to assist Romana in establishing its mortgage sector. The financing process for Ro-Fin offers an interesting view of international collaboration among donors, international financial institutions, and private capital. Leveraging on equity capital of $3 million from RAEF sources, including USAID, funds have been committed from The European Bank for Reconstruction and Development (EBRD), the International Finance Corporation (IFC), DEG (German government funding), and FMO (Dutch government funding). A loan is also expected from Raiffeisen Austria; this will be made possible though a US Government credit guarantee program (the Development Credit Authority).

1.3 Mortgage Loan Products

As further discussed in Section 2.0 below, mortgage loans can be made in Romania under two laws—the Banking Law, which allows licensed banks to make loans secured by real property, and the Mortgage Law, which also allows "other financial institutions" to make mortgage loans. The Mortgage law requires that loans be for more than 10 years and that the loan can be secured only with the real estate. Previously, many bank loans have been for shorter terms and required other security, but the trend is now toward bank loans that meet the requirements of the Mortgage Law.

Loans are offered primarily in ROL (Romanian lei) but also in $US and Euro. Variable rates predominate. Although the maximum stated LTV (loan-to-value) ratios for some banks range from 70 percent to 85 percent, in practice they are often considerably lower. Ro-Fin's average LTV is just over 50 percent, for example.

Loan terms range from 5 to 15 years, but as noted above, many loans have been less than 10 years. Alpha Bank extends 10 year loans in $US at 12.5 percent; only $US and Euro loans are offered, and can be either fixed or variable. Similarly, HVB offers variable rate products in $US at a competitive rate of 8.8 percent and in Euro at 10.3 percent; rates are based on LIBOR and EURIBOR. HVB indicates that it is targeting the top end of the market.

Ro-Fin's average weighted term is under just 10 years; its $US loans carry interest rates of 11 to 13 percent, with an average rate of 12.3 percent. Ro-Fin bases its rates on the 6 month LIBOR.

As another example, the term for BCA'S ROL loans is 15 years, while those in $US have a maximum term of 10 years. BCR's interest rates for the new mortgage program were, at the end of 2002, 28 to 30 percent for loans in ROL and 8 to 9 percent on loans denominated in $US. BCR targets more modest income households.

Finally, it should be noted that spreads are generally very large. It appears, however, that competition is heating up (for at least at the higher end of the market), which should begin to alleviate this aspect of high costs.

1.4 Underwriting Criteria and Credit Risk

Romanian mortgage loans currently have very low default rates; estimates vary, but nearly all banks state that default rates are 1 percent or less. Most banks active in the market report that they have virtually no defaults, and that they have had no experience with the foreclosure process under the 1999 Law on Mortgage Loans for Real Estate Investment (hereafter "the Mortgage Law"). The foreclosure process is discussed in Section 2.0 below; in general, the law is felt to provide an adequate framework, which will no doubt be tested as the market expands.

1.5 Other Aspects of the Primary Mortgage Market

Credit Bureau—There does not appear to be a strong push toward establishment of a credit bureau at present. One expert notes that three banks would be crucial to the establishment of a credit bureau: BCR, Bank Post, and RBD (Romanian Bank for Development). However, only RBD is pushing for a credit bureau. BCR, for example, so dominates the consumer market that it is reluctant to provide the smaller banks with its extensive internal database. Bank Post is also reluctant. The Romanian National Bank is currently assessing the feasibility of developing a credit scoring system for borrowers; sparse credit information is available for large loans (over ROL 200 million).

Appraisal Policies—For some years, Romania has had the foundations in place for a high quality real estate valuation system. There are many independent valuers who are licensed by the Association of Valuers (ANEVAR). ANEVAR itself has benefited from international assistance from the USAID-financed EERPF (the East European Real Property Foundation) in developing its methodologies and manuals. Valuers use market standards, generally the comparable sales methodology, at least in larger cities.

Real Estate Industry—The real estate industry is well established in Bucharest and other larger cities in Romania. There are two associations of realtors. The first, the Association of Real Estate Agencies, was founded in 1995 with the help of EERPF and the US-based National Association of Realtors. The second, the Union of Real Estate Agents, was created in 2000 under a government ordinance that requires all realtors to take training, pass an examination, and join the Union.

Last year there were 80,000 transactions in real estate, 90 percent of which were residential. Professional realtors participated in about 55 to 60 percent of these transactions. The realtor's commission averages 6 percent usually split between the buyer and the seller. Realtors typically have fairly sophisticated databases of properties and sales prices, and web sites listing properties on the market. The web sites are not linked, however; there is no sharing of sales information among realtors and no "multiple listing service" per se.

2.0 THE LEGAL INFRASTRUCTURE OF MORTGAGE LENDING

2.1 Foreclosure

Romanian law generally provides a good framework for foreclosure. Because the procedures are untested, however, it is not clear what defenses a debtor might raise and how long this might delay the process.

Both the Mortgage Law and the Banking Law (see below) provide that if the lender is a licensed bank or "other financial institution," it has "executory title" to the property so long as this is stated in the loan agreement. With executory title, the lender can foreclose through execution officers that are employees of the lending institution, without a court procedure or judgment. The lender, through its execution officers, need only apply to the court for an administrative act authorizing a foreclosure sale—no hearing, trial, or judgment is necessary.

The law provides time periods for notice to the debtor, for publication of details of the auction of the property, and for the auction itself. Assuming no problems arise during the procedure, the shortest possible time period, given the notice periods, is approximately 100 days. If the debtor initiates a legal challenge to the procedure, the foreclosure process proceeds unless the court orders that it stop until the challenge can be heard. Presumably, the debtor would have to present strong factual evidence that the foreclosure is improper in order to stop the process.

The Mortgage Law affords a debtor who is a natural person the right to reside in the property for 90 days after foreclosure. If the debtor refuses to vacate after that time, a court proceeding would be necessary to effect the eviction. The Mortgage Law provides that the court should grant this request in "extraordinary circumstances," such as the presence of children. Romanian experts believe that because of social and judicial reluctance to evict, such requests would be routinely granted. The 90-day "grace" period is a holdover from the social protection afforded tenants under socialism; it is not clear whether it will result in discounts in foreclosure sales because of the uncertainty of whether and when the buyer can gain possession of the subject property.

The minimum costs include the fee for the execution officer (1 percent of the value of the claim). All costs, including advertising, the real estate broker's fee, or any other legal or enforcement expenses, have first priority in payment from the proceeds of the sale.

Auction process—Before an auction can be held, there must be a court-issued administrative act authorizing the sale. Then the lender, through the execution officer, formally notifies the debtor that the sale will take place, and registers the notification in the real property records so that interested third parties will have notice of the sale. Public notice must be posted with information about the sale, which must take place within 30 to 60 days of the notice, and the fair market value of the property. Providing the debtors have failed to remedy the default, the execution officer may commence the sale at the published time. The lender may bid to purchase the property, but may not pay less than 75 percent of the appraised market value.

2.2 Basic Enabling Laws

Mortgage Law and the Banking Law—As noted, mortgage loans can be made in Romania under two laws—the Banking Law, which allows licensed banks to make loans secured by real property, and the Mortgage Law, which allows "other financial institutions," in addition to banks, to make mortgage loans. Previously, most bank loans were made under the Banking Law, since the Mortgage law requires that loans be for more than 10 years. Borrowers may be natural persons who are citizens and residents of Romania, or Romanian legal persons engaged in construction or rehabilitation of real estate.

The Mortgage Law also provides a rudimentary framework for issuance of mortgage bonds or mortgage-backed securities. Experts consider the law as it now stands to be inadequately detailed for purposes of securitizing mortgage loans or issuing mortgage bonds. Regulations are incomplete and responsible agencies not clearly established for purposes of operating and supervising a secondary market.

Title and ownership rights in real property—Laws on ownership and other property rights are adequate and complete for operation of the mortgage market. A number of previously nationalized properties are still subject to restitution claims, particularly in Bucharest. This complicates their sale or mortgage, but the properties subject to restitution claims are clearly identified so this does not unduly affect the general real estate market.

Law on use of real estate as collateral for loan—Loans can be collateralized with real property under the Mortgage Law of 1999 or the Banking Law of 1998. The Mortgage Law allows for loans to be secured by future (to-be constructed) property. As the property is built, it becomes subject to the mortgage; modification in the value of the property does not require modification to the initial registration. These provisions were included in the law to allow ANL—the National Housing Agency—to develop and finance the sale of housing.

The Mortgage Law provides that the borrower must insure the property for the entire term of the mortgage contract. Banks often have their own insurance subsidiaries, but the law requires that the borrower be allowed to select the insurer. Many lenders require life insurance on the principal borrower, although this is not mandated by law.

Property Registration Law—The primary law is the Real Estate Registration and Cadaster Law of 1996, which provides for an integrated registry and cadaster. Romania has a strong system for registration of real estate and mortgages. In many areas of the country, ownership records were reasonably well kept up during socialist years. While not all properties have yet been mapped and included in the cadaster, this is primarily an administrative problem that will be solved with time. The head of the cadaster expects the process of cadaster mapping and parcel assignment to be complete in 2007. In the meantime, if an owner wants to sell or mortgage property, he can obtain a technical survey from a licensed surveyor and submit the documentation to the judet (regional) office of the cadaster. This is sufficient for the owner to obtain a cadaster number and to register the property in the legal registry. The cadaster is under the jurisdiction of the Ministry of Public Administration. The land book or legal registry is administered by the Ministry of Justice and the courts. Properties have parcels numbers that are used in both, and the two systems are linked electronically.

The principal problem with the law is that there is no requirement under the current law for property to be registered in the land book, although the Ministry of Justice is planning to amend the law to require registration for all newly constructed real estate. Now, in many cases a property will not be registered until the owner wants to sell or mortgage it. Mortgages must be registered to be enforceable against third parties, such as other creditors, and to preserve the lender's rights.

There is a satisfactory system for registering apartments that have been privatized. Not all apartments need be registered at the same time, since each building has a cadaster number and each flat has sub-number that identifies it as a separate parcel of real estate.

Liens against personal or moveable property are registered in an electronic archive. Many mortgages are also registered here to assure that the lender's priority is protected in case the borrower defaults on a loan secured by moveable property as well as real estate.

The registration process can be completed in one week if the papers are in order. In Bucharest, it may take longer because of the larger volume of documents submitted for registration.

Law on Execution Priorities—The Civil Procedure Code provides priorities of claims in case of involuntary sale of real estate. The costs of the sale are paid first. Secured lenders claims registered in the land registry have priority over state or local government claims (such as for taxes) unless liens for those claims were registered prior to the mortgage lien. The same principle of priorities—based on chronology of registration—applies in bankruptcy proceedings.

Taxes, Fees and Expenses—Transaction costs for the transfer of real estate range between 2 and 4 percent of the sales price, in addition to the realtor's commission of 6 percent. Annual property taxes are assessed by local governments. They are calculated as 0.5 percent of the first property owned by the taxpayer, 0.75 percent of the second property and 1.0 percent of the third property. Property taxes are not assessed on newly built properties for the first 10 years. There are no tax benefits resulting from transaction fees or interest paid on mortgage loans.

3.0 SECONDARY MARKET AND FUNDING ISSUES

3.1 Bank Funding Strategies

Current funding of mortgages is primarily from demand deposits; there is little external funding. As noted, privatization of the banking sector is recent and still incomplete; thus, restructuring is still a work in progress and the impact of foreign ownership remains moderate. Risk management at Romanian banks is still quite basic. The managers of most banks making mortgage loans are aware of maturity mismatches, but only a few banks are concerned at present. Banks are also now somewhat more aware of the potential for mortgage-backed debt and off-balance sheet funding after responding to a survey undertaken by RAEF.

BCR, as the largest lender, has expressed concern with the lack of longer-term funds. In part to alleviate this problem, BCR has lines of credit from EBRD ($50 million) and IFC ($70 million). Interestingly, BCR stated that it plans to issue mortgage bonds during 2003; the bank notes an urgent need for a secondary mortgage market and is aware that the legal infrastructure necessary for its development is incomplete.

As is typical of recovering economies imposing tight monetary policies, the bankers predict that the Government debt market would "crowd out" mortgage-backed debt, with returns on Government paper rendering capital market funding of mortgages not cost-competitive with deposits.

The locally owned banks have fewer funding options than their foreign-owned counterparts. Current funding of locally owned banks comes primarily from demand deposits; little external funding is utilized. The high domestic cost of capital is likely to mean that mortgage securities, once a sufficient packet size becomes available, would most likely be sold offshore to achieve optimal funding costs.

3.2 Legal Infrastructure for Secondary Mortgage Market

While the Mortgage Law allows for issuance of mortgage bonds or securities, it is regarded as insufficiently detailed or clear to support a secondary market in mortgage debt, as discussed above. The Ministry of Finance is working on additional legislation to clarify many unresolved issues in the current law.

For example, the law provides that financial institutions that are authorized to grant mortgage loans may assign the claims in their portfolio to entities authorized to operate on the capital market. Neither the Mortgage Law nor secondary legislation defines or explains the term "institution/entity authorized to operate on the capital market. "The Law should be clarified as to what institutions are authorized to operate on the capital market, and thus to be assignors and assignees of mortgage loans.

The law does not sufficiently distinguish between mortgage bonds and securities. Tax treatment and accounting regulations are not elaborated. In addition, the Mortgage Law sets forth that mortgage claims can be pooled for assignment only if they are alike with respect to nature (class of property), origin, terms, and risks. Again, these provisions are not sufficiently clear.

Off-shore entities are not qualified as mortgage lenders under the Mortgage Law. Offshore entities may grant ordinary loans, but not mortgage loans.

Capitalization requirements—The Mortgage Law imposes cover requirements that are regarded as too high: 75 percent of the portfolio value can be issued in the form of mortgage-backed securities and 60 percent in the form of mortgage bonds.

Reporting and disclosure requirements—Disclosure, reporting, and accounting requirements are not adequately detailed or regulated at the present time. Efforts are underway to develop a more complete regulatory framework for mortgage-backed debt, but at the present time it is not clear if the principal regulatory body should be the National Bank of Romania or the Securities Commission.

Bondholder's priority rights in the event of bankruptcy of issuer—The Mortgage Law does not provide a preferential right of mortgage security holders over other creditors to the underlying portfolio of mortgage claims.

3.3 Capital Market Profile

Romania's Capital Markets are a reflection of the country's recent macro-economic history. As discussed, economic stagnation plagued the country during the mid-1990s, a condition clearly reflected in its underdeveloped domestic capital market. More recently, the process of reform has gained momentum, a process paralleled by a steady improvement in its macro-economic climate. Market perception of Romania has also improved. Romania's sovereign rating has improved (Moody's recently upgraded its foreign debt to B1, S&P to B+). Romania's "risk premium'' has declined more rapidly than those of its neighbors over the past year.

The market for debt instruments is undeveloped—Treasury bills, corporate bonds, and other debt instruments are not publicly listed, and are sold onto the primary market and traded outside the exchanges. Issuance of corporate bonds is rare. However, Romania possesses the necessary 'market infrastructure' for a developed debt market: market regulators, securities exchanges (the Bucharest Stock Exchange just celebrated its 120 year anniversary) and a depositary. Despite these positive trends, the economic environment is not yet optimal for the development of a domestic debt market. The Government's longest local currency notes have two-year maturities. One-year Government bills recently hit a record low at a nominal rate of 18 percent. Some local currency municipal bonds have been issued recently. Big corporations and state owned entities still issue offshore if they are able. The Government's funding strategy clearly reflects this; cheaper offshore funding remains the favored strategy.

Romania is a large country and ultimately has the potential to develop a large mortgage portfolio. It also has the potential for selling mortgage securities either domestically or offshore; the economics of achieving optimal funding costs will, among other things, determine this mix.

3.4 Potential Investors: Pension Funds and Insurance Companies

The "buy" side in Romania is not as diversified as elsewhere in SEE. One banker noted that Romania simply has no major institutional investors. The principal buyers of government securities are local banks. Government bills are sold into a primary market, which is largely a "buy and hold" operation. The mutual fund sector is still undeveloped, due in part to recent scandals and the resultant lack of investor confidence in such investment vehicles. Romania's privatization funds are largely illiquid, and do not represent substantial purchasing power for securities.

Finally, the reform of Romania's public pension system has been pending for years, and has yet to begin. A pension reform law was passed in 2000, but abrogated in 2001, so pension fund investment allocation rules are not in place. Draft legislation is currently being considered, but some skepticism exists about whether and when pension reform will occur given the history of previous abortive efforts. All this means a limited number of effective domestic investors for non-government fixed income products. Local buying power is largely confined to banks and insurance companies. However, Romania has been successful in selling government and large corporate securities into an offshore market, a process further encouraged by recent credit upgrades for the sovereign.

For insurance companies, investments in securities or non-government bonds are limited to 20 percent of assets.

3.5 National Bank and other Regulatory Policies Impacting Investor Rules

As noted, mortgage lending can take place under either the Mortgage or the Banking Law. This has led to debate over which institution—the Central Bank or the Ministry of Finance should regulate and supervise mortgage lending. For example, as an NBFI (non-bank financial institution), Ro-Fin is not under the regulatory umbrella of the Central Bank. This issue will need to be addressed as mortgage lending increases; responsibility should be consolidated under one institution.

The National Bank and Ministry of Finance are slowly improving domestic debt market conditions. Portfolio investment is largely unregulated, with the exception that state bonds are available to foreign investors only under certain circumstances. Capital gains (and principal) may be freely repatriated, and are taxable only when a foreign investor "has a permanent residence in Romania." Interest income on treasury bills (and bonds of the National Housing Agency) is tax free, while interest income from corporate bonds (and presumably mortgage bonds) is subject to a 10 percent withholding tax.

3.6 European and Regional Issues in Funding and Standardization

Romania is on track for inclusion in the second round of EU expansion, possibly as early as 2007. The process of harmonization of financial sector regulations with EU requirements is not very advanced. As of the mid-2002 Romania had only closed nine chapters, and had yet to open discussions with respect to "financial control" and "financial/budgetary provisions."

Romanian law does not yet comply with the EU recommendation that mortgage bonds be given low risk weight treatment, such as that given to government bonds.