DEVELOPING SECONDARY MORTGAGE MARKETS IN SOUTHEAST EUROPE

ASSESSMENTS OF THE MORTGAGE MARKETS IN BULGARIA, CROATIA, AND ROMANIA

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EXECUTIVE SUMMARY

Bulgaria has now emerged from the severe economic and banking crisis of the mid-1990s, and stands poised to reap the benefits of resumption in economic growth and a continued fall in inflation. Bulgaria has nearly completed the privatization and rationalization of its banking sector and continues to put in place a legal infrastructure that will be highly supportive of mortgage lending. Demand is still relatively weak, and thus the mortgage portfolio is very small, about $100 million, but it should continue to grow if positive trends in income growth and monetary stability continue.

Although funding of mortgage loans is still largely achieved through deposits, Bulgaria has passed a mortgage bond law, which is the first in the region. The law is flexible, especially in that it does not require establishment of separate mortgage banks. Five banks have already issued mortgage bonds, which have been quickly purchased by the pension funds. These banks are Bulgarian American Credit Bank (BABC, two issuances), Express Bank, Post Bank, Economic and Investment Bank, and First Investment Bank. United Bulgarian Bank (UBB) is also planning to issue a mortgage bond.

Pension reform is largely completed and the demand by the pension funds for alternatives to investing in Government securities, in combination with a capital market profile favorable to development of the mortgage bond market, will help assure the success of this risk management strategy in the future. In addition, Bulgaria is now working on further institutional and legal initiatives—a credit bureau and law supporting development of SPVs (Special Purpose Vehicles), which will assist in the creation of MBS (mortgage-backed securities).

A livelier mortgage market should emerge as the past dominance in mortgage lending of the State Savings Bank (DSK) decreases and a more competitive lending environment continues to grow, together with continued recovery in the economic environment.

Some barriers to mortgage market development remain. While Bulgaria has generally adopted an adequate legal framework to support the mortgage market, there has been little legal reform of the loan recovery process, a factor that increases risk in the primary market. Foreclosure procedures under the Civil Procedure Code and the Execution Law require a court procedure and are described as “fiercely pro-debtor.” Inadequate judicial resources further delay the process, especially in Sofia and other large cities. Also, interest rate spreads may remain high, reflecting foreclosure and other risks facing the banks as well as inefficiencies in bank operations and information systems. In summary, however, Bulgaria has made major strides in overcoming its structural and economic crises and adopting an overall systemic reform that will provide important support to efficient and effective consumer and mortgage lending in the future.

1.0 OVERVIEW OF THE PRIMARY MORTGAGE MARKET

1.1 Overview of Banking System and Economic Environment

Bulgaria has achieved considerable success in its efforts to provide a stable and dynamic macro-economic and monetary environment, having now emerged from the major economic crisis suffered in the mid-1990s. Real GDP per capita had plummeted and inflation had reached 578.6 percent by 1997. The recovery is well underway, however. According to the Bulgarian National Bank (BNB), real GDP reached pre-crisis levels in 2002. Inflation has been largely tamed, standing at about 9.0 percent in 2002 and expected to fall to 5.5 percent in 2003. Under Bulgaria's Currency Board, the Bulgarian level (BGN) is fixed to the Euro.

The economic crisis also engulfed the banking system, and in 1996 and 1997, the sector experienced a severe collapse. Eighteen banks were closed, amounting to about one-third of the banking sector. Poor behavioral practices by the banks, including inadequate internal controls, insider lending, and inadequate risk management, led to large numbers of bad loans.[1] There were institutional weaknesses including inadequate capitalization, and poorly developed regulation and supervision, including insufficient enforcement of prudential standards.

The banking system is now on its way to recovery. Although privatization occurred more slowly than planned, the sector is finally nearly fully privatized, with much of the controlling interest in Bulgaria's commercial banks sold to strategic investors. The new owners include major Italian, Greek, French and American institutions, and about 80 percent of the banking system is now foreign-owned. The principal exception is the State Savings Bank (DSK), privatization of which has experienced major delays and barriers. DSK is now scheduled to be privatized in June 2003.

While privatization is relatively recent, its effects are becoming increasingly noticeable. New banking products—car loans, credit cards, leases, mortgages, etc., —are now available. Moreover, banks have begun to move away from portfolio strategies geared to harvesting the gap between cheap deposits and yields on government bonds. Loans are now a growing, but are not yet the dominant element on bank balance sheets. According to one recent report"…the stock of credits to non-financial entities picked up by 34.2 percent in 2002" (Bulgaria Today, Intellinews, 1-02-03).

Recent reforms are gradually improving confidence in the banking sector, and banking assets are slowly increasing again as a share of GDP. Improved prudential regulations, stricter supervisory policies, higher solvency requirements, and bank consolidation and foreign investment are among the positive factors. However, some observers have concluded that Bulgarian banks are currently too risk averse. The capital adequacy ratio is quite high at 20 percent as compared with the required level of 12 percent. And although the banks are liquid, they are generally not adopting an aggressive lending posture.

[1] See "Banking Sector: Bulgaria", Assenka Yonkova, Institute for Market Economics, 2000

1.2 Overview of Consumer and Mortgage Lending in Bulgaria

Based on a study carried out by the Institute for Market Economics (IME) in June 2002, the 10 largest banks doing consumer lending are listed below. Their share of overall consumer lending, which includes mortgage lending, is noted; banks active in the emerging mortgage market are marked with an asterisk.

- State Savings Bank* (DSK): 69%
- SGExpress Bank*: 8%
- UBB* (NBG Group): 6%
- Post Bank* (AIG): 6 %
- Bulbank* (UniCredito): 2%
- Bulgarian American Credit Bank*: 2%
- Biochim (Bank Austria): 2%
- First Investment Bank*: 1%
- ProCredit Bank (EBRD Initiative): 1%

Historically, all mortgage lending was undertaken by DSK. While DSK is still very predominant, it is losing share to over a half dozen competitors. The overall mortgage portfolio was roughly $100 million in the fall of 2002, of which over one-half is held by the DSK (refer to Table 1). Other banks lending for housing include UBB, Post, Bulbank, BACB, First Investment Bank, Express Bank, and Raiffeisen. Data on mortgage loans made by these banks, which is collected by the Bulgarian National Bank (BNB), is also shown in Table 1.

Mortgage lending effectively resumed in 1999 and has grown at an accelerating pace ever since. After a healthy increase of 27.4 percent during 2001, the banks' portfolios grew by 54.3 percent through November 2002. In a relative sense—as a proportion of GDP for example—the total mortgage portfolio is still extremely small, however.

Table 1
Private Sector and DSK Housing Loans Outstanding

Mortgage Loans by Year	December 1999	December 2000	December 2001	November 2002
Mortgage Loans (BGN: 000s)	BGN 80,802	BGN 97,641	BGN 131,360	BGN 179,926
Exchange Rate (BGN for $1.0)	1.947	2.102	2.219	1.970
Mortgage Loans ($000s)	$41,500	$46,451	$59,198	$91,332
Percent Change	N/A	11.9%	27.4%	54.3%

Source: National Bank of Bulgarian and the Institute for Market Economics

Funding of mortgage loans is based largely on deposits, which tend to be very short-term. As further discussed in Section 3.0, although mortgage bonds are being issued, they have been of very modest size. One interesting aspect of the mortgage bond issuances is that they are not yet competitive with funding from deposits. The cost of funds, although varying from bank to bank, is reportedly quite low (around 3 percent) and bond funding is less cost effective. On the other hand, the deposits are very short-term, and the bond issuances may be viewed as test cases for improved risk management strategies via longer-term funding in the future. (As noted below, however, the mortgage bonds themselves have been relatively short-term – 3 years.) Banks are quite liquid and interest rates remain relatively high, in part a function of tight fiscal policy. This, in essence, crowds out private debt. Also, as noted, banks remain somewhat risk averse, and spreads are still felt to be high. Future issuances will, of course, depend on bank liquidity, the need for long-term resources, and the strength in demand brought about by improved affordability.

Nevertheless, all trends are moving in a positive direction. With the entry of new banks into mortgage lending, the past dominance of the DSK is diminishing and the mortgage lending system is increasingly competitive. This should be beneficial to both the rate structure and loan product development in the future.

1.3 Mortgage Loan Products

Banks provide mortgage loans for new housing, existing housing, and rehabilitation. Mortgage loans are primarily denominated in BGN. Terms, which were previously 5 to 10 years, have recently been extended to up to 20 years. The loans are variable rate, with rates updated at the bank's convenience. LTVs (loan-to-value ratio) generally range from 70 to 80 percent (although see the discussion in Section 1.4 below: effective LTVs may be lower).

Mortgage interest rates for loans in BGN have fallen from 17 to 18 percent in 2000 to 12 to 14 percent by the third quarter of 2002. (As a point of comparison, ten-year Government bonds yielded about 8.0 to 8.5 percent at that time.)

As a specific example, DSK's interest rate on its variable rate BGN loans stood at 13.75 percent in the fall of 2002, down from 16 percent in April 2002. Spreads are quite high, as DSK notes that its average cost of funds is 1 percent for demand deposits and 3 to 4 percent for time deposits. The maximum loan term is 15 years and maximum LTV is 80 percent, although loans are more typically at an LTV of 70 percent. Interestingly, loan terms vary according to construction type and building materials, the rationale being that these factors have a major impact on the expected life of the building. Thus, for example, loan terms for panel construction are less liberal than for brick.

Raiffeisen, in contrast, bases its loan terms on a classification scheme for clients, using income level, quality of collateral and credit history among other factors. The bank has targeted upscale borrowers. Interest rates (as of fall 2002) varied from 8.8 to 12.95 percent, and terms from 3 to 7 years; LTV was a maximum of 70 percent.

Post Bank's interest rates depend on the loan term and the currency. Loans in BGN, for example, were at 12.75 percent for 10 years, 13.75 percent for 15 years, and 14.75 percent for a 20-year loan; interest rates for comparable loans in Euro were somewhat lower.

1.4 Underwriting Criteria and Credit Risk

Overall, mortgage loans are performing fairly well and overdue loans represent only 0.3 percent. There is a rather large range, from 1 to 5 percent, across lenders in reported estimates of the number of loans in default (that is, over 90 days overdue). There is little experience with the foreclosure process, however. As discussed in Section 2.1, foreclosure is not a commonly used remedy: it is time consuming and expensive and the outcome is uncertain.

Banks are generally quite conservative in underwriting mortgage loans, sometimes requiring other security such as accounts maintained by the borrower in the bank. In addition, the LTV ratios may be lower than they appear, as banks routinely decrease the appraised value of the property before considering loan size. As discussed below, the appraised value is discounted about 20 percent before the LTV is determined, to compensate for the uncertainty of the lender's ability to recover collateral in event of default. Third-party guarantees were once typically required, but in recent years the use of this security has declined.

1.5 Other Mortgage Market Issues

Credit Bureau—Bulgaria is now working on an institutional initiative that is of key importance to an effective mortgage market—a credit bureau. A thorough analysis has been made of the issues surrounding credit bureau development and a team has visited credit bureaus in other countries, including Turkey and Poland.[2] A feasibility study has been prepared recommending a private credit bureau that would serve not only banks but also utility companies and leasing companies. It is also hoped that the SME sector would be included. One key problem concerns reporting of "positive" customer credit information; a legal constraint stems from bank secrecy requirements, and thus collection of positive credit information would require a change in the Banking Act and Personal Data Collection Act. A number of the major Bulgarian banks have stated their willingness to become shareholders, and the remaining banks would be expected to pay a fee for services. However, given the dominance of DSK in consumer and mortgage lending, its participation is crucial, and the bank is waiting until after its privatization to commit to the credit bureau.

Currently, the National Bank of Bulgaria maintains a central credit registry; however, this covers only loans over EU 5,000, and it is felt that banks do not fully comply with reporting requirements.

Appraisal—The Mortgage Bond Law provides a number of options for appraisal methodologies for mortgages underlying bonds–comparable sales, revenue generation, and material value (replacement cost). Independent appraisers are active and are certified by the Privatization Agency. Some banks, however, have not been fully satisfied with the available valuers nor with the valuation methodologies as applied to residential real estate lending. Thus, many banks have their own appraisers, although they sometimes rely on the independent appraisers, who are often affiliated with real estate agencies. The bank selects the valuer and pays for the appraisal.

The overall valuation process as applied to the underwriting function remains flawed, however, especially in determining value based on the "market comparables" methodology. First, banks still do not appear to trust the appraisal process, because appraised values are slashed by as much as 20 percent

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[2] The Institute or Market Economics and the Bulgarian American Credit Bank have both been very active in the research process and policy dialogue supporting formation of a credit bureau.

when determining the mortgage loan amounts. (BACB notes that it used to slash the independent appraisals, but has now developed an improved in-house valuation capacity.) Second, properties are registered at less than appraised value; this makes utilization of the comparables approach very difficult.

Taxes—Because of the two percent transfer tax, many sales are reported at lower than actual value. This makes it difficult to conduct appraisals strictly by the comparable-sales method. As the market has matured, this factor is usually taken into account. Because of loan recovery difficulties, however, mortgages are still given on substantially less than real market value, as noted.

Real Estate Industry—The real estate industry is well established in Bulgaria, particularly in Sofia and other major cities, and the resort areas on the coast. There is a National Real Property Association that issues standards for the industry, but they are not mandatory. Many realtors also provide appraisal services. In the last year, there were approximately 100,000 sales of real estate in Bulgaria. Estimates of sales with mortgages range from 2,500 to 15,000. Realtors generally charge a commission of 5 percent of the sales price, which is usually split by the buyer and the seller.

Realtors typically have sophisticated databases of properties and sales prices, and web sites listing properties on the market. While there is no formal multiple listing services, five of the largest realtors in Sofia, all of which handle sales and appraisals, share information on a voluntary basis. This program is called “Info-Pool.” The primary form of advertising is though the newspaper, not via web sites.

2.0 LEGAL ISSUES IN THE MORTGAGE MARKET

2.1 Foreclosure

The most serious constraint to the expansion of mortgages lending, and to further development of mortgage bonds and/or MBS is the difficult and lengthy foreclosure system. There have been only a few foreclosures, but the banks have had enough experience to testify that the system is difficult and very time consuming. Implementation is the major drawback: there are too few judges and they are said to be not sufficiently knowledgeable about the process. The debtor can appeal the process at many stages, and as a result, foreclosure takes one to two years. Foreclosure is said to work better in smaller locales than in the large urban areas, due to a severe shortage of judges in the latter.

A court judgment is required, and the “executive judge” (judge with authority to oversee execution procedures) supervises each step, including appraisal of the property, public sale or auction, and eviction. The debtor has many opportunities to challenge the procedure or appeal the decisions of the court.

Costs include court and legal fees, the costs of auctioning the property, and the diminution in value of the property as a result of delays and uncertainty in the foreclosure and eviction process.

Auction process—Auction procedures must be supervised by the court; no private sales are permitted through the foreclosure process. The time periods provided in the law are similar to those of other countries, with the minimum time to foreclosure about 6 months, but because of the debtor’s right to challenge the procedures, completion of a foreclosure can be expected to take much longer than the minimum time.

2.2 *Mortgage Bond Law*

As noted, Bulgaria adopted a Mortgage Bond Law in 2000.[3] Several banks have issued bonds under the new law, and more issuances are planned. The law does not establish specialized mortgage banks or provide government guarantees or subsidies, so the primary mortgage market has been allowed to develop according to market-driven factors. Any banks licensed by the Bulgarian National Bank can issue bonds collateralized by the bank's mortgage debt or other assets in accordance with regulations set by BNB. The collateral value is discounted from the mortgage appraisal value to minimize risk from temporary imbalances in cash flow or liquidity. The bank maintains a confidential register for collateral for bond issues, which may not be otherwise burdened.

Separation of mortgage collateral from other assets—The current Mortgage Bond Law in Bulgaria requires segregation of assets that are committed to guarantee the bonds in the event of insolvency of the lender. There can be no off -balance sheet issues. Legislation on a special purpose vehicle is under consideration, however, which would enable this type of issuance.

Bondholder's priority rights in the event of bankruptcy of issuer—Under the Mortgage Bond Law, proceeds from liquidation go first to bond holders.

Reporting and disclosure requirements—Special transparency and disclosure requirements for publicly offered mortgage bonds are regulated by State Securities Commission under the Public Offering of Securities Act. Non-public offerings are legally possible but impractical because insurance companies and pension funds—the primary investors in mortgage bonds—can invest only in the regulated public market. There is no special trustee for mortgage bonds, but rather the Bulgarian National Bank looks at a bank overall.

Reportedly, there have been substantial improvements in transparency and disclosure in the general banking sector in the last several years. However, the BNB credit registry does not provide public information on borrowers, nor does BNB regularly disclose bank-rating information.

2.3 *Basic Enabling Laws*

Title and ownership rights in real property—Ownership and other property rights, covered in the Constitution and the Property Law, are adequately complete and clear for operation of the mortgage market. Foreign persons (legal and natural) may own property in Bulgaria with the consent of the Ministry of Finance. Bulgaria has historically had a very high percentage of homeownership. Even before privatization in the post-socialist period, over 90 percent of the population owned their homes. Today, the number is 97 percent.

Law on use of real estate as collateral for loan—The Property Law expressly permits the owner of property to use it as collateral for a loan. The property register maintained by the district courts is the

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[3] Among others, the Bulgarian American Enterprise Fund, the Bulgarian American Credit Bank, and IME were active in developing and promoting the Mortgage Banking Law.

official repository of mortgage liens on real property. Notaries maintain records of mortgage contracts they have prepared but these are not maintained in any central database; only the property registers have records of all mortgages or other liens on property (such as tax liens).

Property Registration Law—The district courts maintain a legal registry of ownership and other interests in real estate. Registration of title or mortgages in Bulgaria is reported to be very speedy–as little as 24 hours from submission of documentation to completion of registration. Title to property does not transfer until registration is complete. In practice, the registration paperwork is generally handled by notaries, but a lender, owner or any interested party can submit the documentation.

The legal registry and cadastre are not yet unified; however, there is a World Bank project underway to improve the data entry and retrieval system and to integrate the legal and mapping records. One major problem with the current registration system is that properties are listed by owner rather than by parcel number. Co-owners are not listed together, so all owners must be known and checked before a lender can determine with certainty that there is no lien against the property they jointly own.

Law on Execution—Execution is conducted under the Civil Procedure Code and the Law on Obligations and Contracts Law, in accordance with the foreclosure procedures discussed above. Secured creditors are paid after the costs of the foreclosure procedures. If there is more than one secured creditor, they are paid in the same order that their rights were registered.

2.4 Fees and Expenses

Costs of transaction—Notary fees are regulated by law and are based on a percentage of the value of the transaction, with the percentage increasing with the size of the transaction, up to a maximum of 3,000 leva (about $1,500). Notaries’ fees average 0.8 percent of the value of the transaction.

Transfer and registration fees—Transfer and registration fees equal 2 percent of the value of the transaction.

Tax Treatment of Transaction Fees, Mortgage Interest—There are no tax benefits resulting from transaction fees or interest paid on mortgage loans.

3.0 SECONDARY MORTGAGE MARKET AND FUNDING ISSUES

3.1 Bank Funding Strategies

Better market conditions and growing competition in the primary mortgage market have led to improved terms for borrowers and a renaissance in mortgage lending. As portfolios grow, however, this will ultimately lead, however, to a worsening maturity mismatch between bank funding and mortgage lending.

Funding of mortgages is still achieved largely through deposits. There is some external funding through parent institutions and syndicated credits. Privatization has meant that Bulgaria's banks may now be less dependent upon their deposit base to fund bank activities, and are subject to additional oversight of their risk management strategies. Nonetheless, deposits account for the bulk of bank funds; furthermore the deposits are of very short duration.

Unlike some of the other transition nations, however, Bulgaria has shown real interest in maturity matching. To Bulgaria's credit, it has passed a mortgage bond law, which provides for on-balance sheet transactions. The law, which is the first in the Southeast Europe region, is modeled after the German Pfand brief' model, but is more flexible, especially in that it does not require establishment of separate mortgage banks. The law provides only for on-balance sheet transactions.

Five banks have already issued mortgage bonds, which have been quickly purchased by the pension funds. These banks are BABC (two issuances, EU 8 million), Express Bank, Post Bank, Economic and Investment Bank, and First Investment Bank. UBB is also planning to issue a mortgage bond. Thus, these early mortgage bonds have begun to correct the duration gap problem. All of the mortgage bonds to date have been on balance sheet, of very modest size, and sold locally. Small issue size has been one of the barriers inhibiting accessing less expensive offshore funds through a foreign bond issue. This said, the first offshore transaction is now in preparation. If successful, it should create greater funding flexibility.

One quite interesting aspect of the mortgage bond issuances is that they are not yet competitive with funding from deposits. Raiffeisen Bank notes, as a consequence, that bond issuance appears to be a "boutique" competition, and that it will not consider mortgage bonds until they are cost-competitive. The bonds are also relatively short-term–3 years–compared to loan terms ranging from 10 to 15 or more years. Key lenders have indicated that they expect the term of the mortgage bonds to increase to 5 years in the near future; this is well in line with an average real life of 5 to 7 years for mortgage loans. In sum then, more complex bank risk management strategies are now emerging.

SPV Law—A law supporting a special purpose vehicle (SPV) is now under development. The intention is to support development of off-balance sheet securitization, and the issuance of mortgage-backed securities (MBS). This movement is intended to provide a structure for off-balance sheet transactions, thus paving the way for greater flexibility in risk management.

3.2 Capital Market Profile

Bulgaria has put in place all the basic laws and institutions for the development of its capital market. This includes a modern and efficient stock exchange and depository as well as a Securities Commission. In addition, improved new legislation concerning trusts and special purpose vehicles is under consideration.

Bulgaria's capital market profile and monetary management are now very favorable for development of a mortgage bond market. Bulgaria's Currency Board, together with favorable monetary and fiscal policies, has produced currency stability and brought interest and inflation rates down to more reasonable levels. As a result, Bulgaria continues to provide a domestic market that is favorable to the development of mortgage securities. Overall debt management has been sound. The ratio of external debt to GDP continues to decline. The domestic debt market is small but orderly. The Ministry of Finance has developed a sound and predictable issuance program, coupled with an extension of maturities. The Government is currently able to issue local currency bonds with up to 10-year maturities into the domestic market at reasonable prices.

As in most countries in the region, the preponderant debt market products are government securities. Given the relatively low prevailing interest rates, the pricing on Government Bonds has been both moderate and predictable. This has permitted private issuers to raise funds at less than the cost of bank loans. As a result there is a growing list of private (and non-sovereign) issuers, including public utilities, small and medium sized companies, municipalities and bank issuance of mortgage bonds.

3.3 Potential Investors: Pension Funds and Insurance Companies

Bulgarian pension reform is largely completed. Pension reform is covered by the Mandatory Social Insurance Code of 1999. The Government has passed "Pillar Two" and "Pillar Three" legislation. Liquidity in the system is growing rapidly in the licensed pension funds, and is anticipated to exceed $ US 1 billion by year-end 2005. The demand for quality long-term debt other than government paper is extremely high among Bulgaria's pension funds. Nonetheless, there are restrictions on the amount that any fund can invest in different asset categories, including: securities of a single issuer, amount invested abroad, and percentage of assets in government securities. The Law on Securities, Stock Exchange and Investment Companies addresses the regulation of securities and investment activities. These rules are now subject to review, with likely outcome that the amount of pension funds that can be invested abroad will be expanded. Pension funds and insurance companies have purchased the bulk of the five mortgage bonds issued to-date.

Bulgaria also has private insurance companies. The insurance sector, which is in the early stages of market-based development, is regulated under the Insurance Business Act.

3.4 Central Bank Regulatory Policy

Under the Currency Board, the Central Bank retains fewer monetary functions. Bank supervision is one of its key tasks, however. Under the Law on Banks and the Law on the Bulgarian National Bank of 1997, the BNB has a strong mandate to supervise and regulate banks. BNB issues prudential regulations in the areas of capital, liquidity, loan classification and provisioning, credit concentration, disclosure, auditing, risk exposures and connected lending and investments, all of which are generally in line with international standards. A risk weighted capital adequacy ratio of 12 percent is required; as noted, Bulgarian banks generally remain well above this limit with high capital and liquidity ratios.

At present, National Bank officials indicated they were not immediately concerned about the adequacy of risk management capabilities of banks under its supervision. Hence increased regulatory action to enforce a closer matching of maturities seems unlikely. In addition, pension fund regulators and the Securities Commission each have separate jurisdiction and oversight. Thus banks, pension funds, and mutual funds are subject to separate regulatory oversight. Some discussion has been held of unifying these functions, but no action has yet been taken. The pension fund regulator has imposed an asset allocation system applicable to a mature market on the current emerging capital market. (See above).

3.5 European and Regional Issues in Funding and Standardization

Coming out of the Copenhagen Summit, the earliest possible date for Bulgarian accession to EU is 2007. Nonetheless, Bulgaria is well advanced in the process of harmonizing legal and administrative "Chapters". However, National Bank sources do not envision significant changes in bank supervisory practices, especially as regards risk management.

ASSESSMENT OF THE CROATIAN MORTGAGE MARKET

EXECUTIVE SUMMARY

Mortgage lending in Croatia is dynamic and growing, market-based and increasingly competitive. Bank privatization in Croatia is largely complete, and spreads have begun to fall as a result of strong competition. Commercial bank policies and market forces have, together, established a structure of mortgage lending (loan terms, interest rates, etc.) and underwriting standards, including the LTV (loan-to-value ratio), borrower cash flow, and guarantor system, that is clearly appealing to Croatian households. Thus, as a proportion of GDP, mortgage lending in Croatia is among the leaders in the region.

The basic enabling laws for a primary market in mortgage finance are in place. Concerns remain, however, with certain aspects of the legal infrastructure, especially foreclosure, and with the guarantor and mandatory deposit systems that often serve as substitute collateral for the mortgaged property. Most mortgage loans, at least until recently, have been secured by third-party guarantee and by other property of the borrower as well as with a lien on the subject property. Foreclosure and eviction require a court procedure and are extremely slow and uncertain. A second legal impediment to development of the market results from the fact that many properties are not legally registered in the property records.

In addition, despite longer-term mortgage loans being offered, no movement has yet taken place with regard to longer-term funding of mortgages from the capital market. The ingredients for a successful secondary market in mortgages are partially present. There is an ample supply of mortgages, sufficient demand, and a permissive legal and regulatory framework for the development of this market. Capital market funding of mortgages is likely to develop in Croatia, however, as more Croatian bankers become fully aware of the financial and fiduciary benefits of a secondary mortgage market; they are not now convinced that the sale of their mortgage portfolios is financially attractive under current market conditions.

1.0 OVERVIEW OF THE PRIMARY MORTGAGE MARKET

1.1 Overview of the Banking Sector and Economic Environment

The banking sector in Croatia, having already gone through several stages of privatization, foreign investment, and consolidation, is now well established[4]. Major restructuring occurred during 1999, which witnessed a banking crisis and the closure of a number of smaller private banks. Privatization of large state-owned banks has been completed; together with bank consolidation, mergers, and bank closures, the banking structure that has emerged appears to be appropriately restructured and stabilized. The new owners are primarily Austrian, Italian and German banks.

The Croatian Bankers Association notes that there are seven major banking groups, as viewed from the perspective of ownership structure. The two largest banks—Zagrebacka and Privredna—have been

[4] See "ECRA Housing Project: Financial Sector Analysis", Leslie Matthews Sulenta, The Urban Institute, July 2001.

[6] Annual Report, Privredna Banka Zagreb, 2000.

particularly active in the acquisition of smaller regional banks and now control roughly 50 percent of the market and a similar proportion of total bank assets. Five other major groups roughly divide the remaining portion of the market. The Croatian Bankers Association has concluded that this new structure is now much more conducive to robust competition. With the increased foreign investment in both large and medium banks, the share of the total assets of the banking system now owned by foreign investors reached 76 percent by the end of 2000. This compares with a figure of 40 percent at the end of 1999.[6] Based on the substantial increase in deposits, it appears that public confidence in the banking system has been restored. This now also appears to be the situation for mortgage lending.

Finally, the economic environment is stable and inflation remains at modest levels, making borrowing affordable and predictable from the perspective of Croatia's households. Indeed, Croatia has had very good economic policies for some years, resulting in high rates of growth, a stable exchange rate, and rates of inflation in the single digits.

1.2 Overview of Consumer and Mortgage Lending

Both mortgage lending and consumer lending are rapidly growing in importance in Croatia. The National Bank of Croatia calculates that outstanding housing loans totaled HRK (Croatian Kuna) 12.1 billion (roughly $1.5 billion) at the end of November 2002. This is a sizeable portfolio for a country of Croatia's size and represents significant progress in a transition nation. The rate of growth in housing loans has accelerated steadily since 1999. Consumer loans have grown even more rapidly, and totaled about $3.7 billion at the end of November. Table 1 summarizes the growth in housing and other consumer lending (primarily credit cards and car loans) since 1999.

The commercial banks are the major source of mortgage lending in Croatia.[8] Croatia has at least 17 major universal banks active in the consumer market, eight of which are major lenders for housing. The key housing lenders are Zagrebacka and Privredna, which together account for over one-half of the mortgage market. Competition between them for mortgage lending is keen, as well as among other major banks, including Splitska Bank, Raiffeisen, HVB Croatia, Erste Bank, Hypo Bank, and Dalmatinska Banka.

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[8] The Croatian Bank for Reconstruction and Development (HBOR) has played an important role in housing lending by providing incentives to commercial banks to make loans to those without adequate housing. Also, the housing savings banks, which are based on the German Bausparkassen model, may play a larger role in the future. They have only just now begun to lend; however, this is savings-based approach to mortgage finance that carries a Government subsidy.

Table 1
Consumer and Housing Lending

Type of Lending	1999	2000	2001	2002 November
Housing Loans	7.3	8.3	9.5	12.1
Other Consumer Loans	11.8	14.9	20.6	29.8
Grand Total	19.2	23.2	30.1	41.9
Percent change: Consumer	N/A	26.3%	38.3%	44.7%
Percent change: Housing	N/A	13.7%	14.5%	27.4%

(Billions of HRK)
Source: National Bank of Croatia

While Croatia has a strong market in real estate loans, weaknesses in the legal framework have caused the market to develop with certain distortions that distinguish it from the typical market-based model of risk management. These include the following:

- Foreclosure and eviction require a court procedure and are extremely slow and uncertain.
- Many properties are not legally registered in the property records.
- Lenders have until recently required third-party guarantors of loans, and relied on them to pay in case of the borrower's default rather than proceeding with foreclosure and sale of the mortgaged property.
- Loan-to-value ratios are relatively low, and to compensate for problems with foreclosure, lenders apply an additional "discount" to appraised value even before applying the LTV ratio.

These issues are discussed below and in Section 2.0.

1.3 Mortgage Loan Products

Mortgage lending practices in Croatia are becoming increasingly flexible and innovative, in response perhaps, to increasing competition among the lenders. Loans of all sizes are being provided, from small rehabilitation loans, to home purchase loans of nearly 2 million HRK. An average size loan from the major lenders ranges from 200,000 to 380,000 HRK (approximately $25,000 to $47,000). Terms may be as long as 20 to 25 years.

Loan-to-value (LTV) ratios are difficult to determine precisely. LTVs generally seem to be around 80 percent, or higher. However, if a mandatory deposit is required (see below), the *effective* LTV is actually much lower. In addition, when a deposit is required, banks must now state an "effective" rate that factors in the cost of tying up these "guarantee deposit" funds.

Interest rates range from about 7.5 percent to 10 percent, depending on factors such as borrower income and credit profiles, use of guarantors, use of mandatory deposits as collateral, and loan size and purpose. Interest rates have fallen, likely in response to falling rates within the economy; however, it may be the case that spreads have also fallen—indicative of a response to competitive pressure.

New mortgage loan products are being introduced; some banks now offer multiple products, with different underwriting rules and interest rates for different clients. This is so-called risk-based pricing, which is a methodology widely utilized in developed market. Thus, loan products exhibit a fair degree of sophistication in many attributes. As a result, a new degree of flexibility has appeared as the banks compete for market share.

Nearly all loans are variable rate loans—in actuality, they might be labeled “double-indexed loans.” First, the vast majority of loans is now indexed to the Euro (and was previously indexed to the DM and other currencies). This is indexation of principle: if the Kuna changes in value , the outstanding principal is changed and thus all subsequent installment payments. Second, loan terms may also include a variable interest rate; in practice, however, banks do not change the rate frequently or according to preset rules. One problem is that there are no formalized internal indices, nor specific rules for the level and frequency of changes in interest rates. Instead, adjustments are made solely by the decisions of the banks, at any time of the banks’ choosing. The ZBOR (Zagreb Interbank Offer Rate) is viewed as too heavily influenced by just two banks to be broadly used as an index. Cost of living indices are also not yet considered as appropriate for this purpose. (Clearly, this represents one of the areas of primary market development that might fall high on Croatia’s list, as well as establishing specific rules rates of change in interest rates and annual ceilings on changes.)

1.4 Underwriting Criteria and Credit Risk

As further discussed in Section 2.0 below, foreclosure is extremely slow, expensive, and uncertain. Given these difficulties, relatively few defaulted loans go into formal foreclosure. Thus, one of the main pillars of mortgage lending in developed countries, the ability to obtain the housing collateral upon default, is currently compromised in Croatia.

A variety of methods are used to get around this problem. First and foremost, most mortgage loans require two (or even more) guarantors. The guarantors are essentially underwritten as if they were paying off the loan; employment in registered industries is often required. The guarantor approach, while substituting for lack of foreclosure, may constrain lending and cause banks to remain unduly conservative. Secondly, as noted, a mandatory deposit with the lending bank may be required, or a deposit of other valuable property. Up to 20 percent of the loan may be required as a deposit.

Third, in addition to mortgage loans secured by a registered lien on the borrower’s property, Croatian law provides for a second type of mortgage arrangement—the fiduciary ownership model, in which the lender holds the borrower’s ownership documents (the deed or title) to the property until the loan is paid (see Section 2.0 below). Fiduciary ownership was developed to address problems in the foreclosure process, but there is general agreement that it is not an effective alternative. As further discussed in Section 2.0, this approach does not alleviate the delays and difficulties in the foreclosure process.

In sum, the current approach to underwriting is a somewhat “second best” approaches, introducing a risk structure into lending with largely unknown dimensions. There is no central registry of guarantors; the guarantors may have undertaken multiple guarantees and/or face a large gross debt position themselves.

Thus, lack of more effective foreclosure undermines the very concept of “mortgage” lending—that is, the use of the property as collateral.

It may now be the case that this situation is changing. The percentage of “true” mortgage loans (without other security such as guarantors) is now estimated to be 10 to 20 percent of the outstanding portfolio. Most existing “true” mortgage loans were made on new properties, where value is easily established and ownership records are clear and properly registered. According to one lender, true mortgage lending is also increasing in other segments of the market; in the last year 7,000 mortgage loans were made and only 2,000 loans required other security.

Delinquency and Default Information on Mortgage Lending—Banks are required to report delinquency and default information to the Central Bank for provisioning purposes. It is somewhat unusual, however, for banks to reveal delinquency and default rates publicly, and especially for a subclass of consumer loans such as mortgage loans. However, four of Croatia’s major mortgage lenders have provided this data, and there seems to be a wide range of delinquency and default rates among banks, ranging from one to five percent. The highest reported delinquency rate was 3.34 percent of the number of loans 90 days or more lately, which represents 3.95 percent of the value of outstanding mortgage loans. Another bank reported a similar rate—3.0 percent—of loans overdue; however, these are reported to account for only 1.5 percent of value. Loan defaults at a third bank account for 5.0 percent of the number of loans and 3.0 percent of value. In contrast, another large bank reported a quite low delinquency and default rate: less than one-half percent delinquency and a negligible default rate.

1.5 Other Aspects of the Primary Mortgage Market

Foreign Exchange Risk—Croatia potentially faces substantial foreign exchange risk. The Kuna floats on international markets and risk arises from indexation of HRK loans to foreign currencies. A recent example of the type of impact that can occur is the 1999 depreciation of the Kuna, leading to a negative repercussion on contracts indexed to DM. As a result, payments for consumer loans increased dramatically. The problem is mitigated by the fact that many deposits are also in foreign currency or indexed to foreign currency. Note that these types of “credit shock” foreign exchange problems are likely to be far more troublesome to modest income borrowers than to those with higher income, as even slight changes in the required monthly payments may cause difficulties.

Titling and Registration—As further discussed in Section 2.0, uncertainties regarding title, inadequate registration, and a low percentage of properties that are legally registered remain other important problems. The problems are reputed to be particularly bad in Zagreb. Without title insurance, loans may be denied to questionable title situations, which is presumably constraining market growth.

Banks will not make mortgage loans on unregistered properties, so this limits the market. This problem is administrative rather than legal, however; efforts to computerize and upgrade the registration system are underway, but it will be many years before the system is fully functional. Croatia has recently closed a 26 million Euro World Bank loan for reform of the land registration and cadastre system. The project will begin in January 2003, and is expected to take considerable time to complete.

Lack of a Credit Bureau or Central Register of Guarantors—Another problem is lack of a central facility—such as a credit bureau—for assessment of the total debt position of would-be borrower. The Croatian Bankers Association has sought to persuade the banks that a credit bureau is in their mutual best interest, and this effort is still underway.

Some lenders are reportedly using the guarantor approach less frequently, at least partly because there is no central register of guarantors. Rather, each notary who prepares loan contracts with guarantors keeps his own records. As a result, it is difficult or impossible for a lender to know the extent of the liabilities of a guarantor—how many other loans he may have guaranteed or what his other debts might be. As the housing lending portfolio expands, this problem grows more serious.

Appraisal Policies—Each of the major banks has a real estate subsidiary to perform appraisals, not only of the subject property but also the borrower's business or other property that may be used as collateral or to evaluate the creditworthiness of the borrower. The appraisers are court-certified and so must meet independent standards. Appraisers are independent; they are certified and regulated by the courts.

Real Estate Industry—The real estate industry is thriving in Zagreb and Dubrovnik and other coastal resort cities, but is quite inactive in other areas because the property markets are reported to be depressed. There are over 20 commercial and residential real estate agencies in Zagreb. A number of realtors in Croatia have sophisticated databases of properties and sales prices, as well as 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

Although Croatia reports a rather wide range of default rates in mortgage lending, 1 to 5 percent as noted above, the incidence of foreclosure is very low. The poor legal framework for foreclosure may explain this apparent paradox. Because a court procedure is required, foreclosure is very slow and the outcome is uncertain. The borrower has many opportunities to appeal. There are also delays in completing auctions because of lack of court-qualified auctioneers.

As noted, Croatian bankers have required other security in addition to the mortgaged property in the form of third-party guarantees or deposit of other valuable property with the lender. Access to guarantors and other collateral has probably served as sufficient recourse in most cases of default so that foreclosure is rarely used.

The typical length of the foreclosure process ranges from 1 to 3 years, depending on the jurisdiction and the defenses or appeals that the borrower raises in court. Foreclosures are reportedly slowest in Zagreb, probably because the courts are most overburdened there. While the time periods are not necessarily much longer than those in a number of other countries, uncertainties in the process result in discounts in size of the loans that lenders are willing to make and also in the price achieved from the sale the property brings at auction after foreclosure.

Because of the requirement of a court procedure, legal costs are higher than necessary. There is also diminution in the value of the property because of uncertainties and delays in the process, particularly with regard to eviction. The salvage value of property after default is believed to be about 25 percent of ordinary market value.

As noted, the major problem is delays and uncertainty resulting from court procedures. This can be exacerbated with a fiduciary mortgage (see the explanation below), as eviction does not take place until after the foreclosure sale–probably the primary reason this procedure is not favored by lenders. Eviction then becomes the buyer's responsibility, which eliminates many potential buyers and lowers the price any buyer is willing to pay.

Auction process—Before an auction can be held, there must be a court-issued Decree on Execution. Then the court orders an appraisal to determine the market value of the property. The debtor has an opportunity to appeal the valuation if he thinks it is too low. The minimum sales price must be 80 percent of the valuation. If no bids are received at that price, another auction is held at least 30 days later, with a minimum sales price of 50 percent of the valuation. After three 3 sales, the bank can buy the property, and then try to sell it for a higher price (presumably closer to true market value).

2.2 Fiduciary Mortgage

In addition to mortgage loans secured by a registered lien on the borrower's property, Croatian law provides for a second type of mortgage arrangement—the fiduciary ownership model. Fiduciary ownership was developed to address problems in the foreclosure process, but there is general agreement that it is not an effective alternative. Under fiduciary ownership, the lender holds the borrower's ownership documents (the deed or title) to the property until the loan is paid. The loan contract stipulates that if the borrower defaults, the lender may sell the property without going through a court procedure.

Under fiduciary ownership, title or legal ownership is not actually transferred to the lender and the lender does not have possessory rights, however. If the borrower does not willingly vacate the property, the lender must go to court for an eviction procedure, or sell the property subject to the occupant's possessory rights and let the buyer deal with the eviction. Because of these problems—the requirement to go to court for eviction or to sell the property at a severely depressed price because it is not vacant—fiduciary ownership mortgages are falling out of favor in general and some of the larger banks will not use them at all.

2.3 Basic Enabling Laws

Title and ownership rights in real property—The basic law is the Law on Possession and Other Real Property Rights of 1996. While the property and ownership rights are adequately set out in the Law, in practice ownership rights are often unclear because the registration records are incomplete.

In addition to incomplete and inadequate registration records, there are two other problems with establishing ownership rights. There are conflicting claims to ownership in areas affected by population displacements during the war, and some properties are affected by restitution claims under the Law on Compensation for Properties taken during Yugoslav Communist Rule (1996). The restitution law provides that in some cases the property itself will be returned to the former owner, while in others the former owner will be entitled to compensation through bonds issues by the state but not return of the property. This adds further uncertainty to the title for those properties.

Law on use of real estate as collateral for loan—The Croatian Law on Ownership, Article 304, defines types of mortgages and specifies that real property may be used as security for a loan. It also requires that a court procedure must precede foreclosure of mortgaged property. As discussed above, until recently most loans were secured by other collateral as well as the subject property and by third-party guarantors. Lenders will not make loans on property that is not properly registered.

Property Registration Law—The basic laws are the Land Registration Act of 1996, the Regulations on Land Registration Procedures of 1997, and Book of Ordinances of the Land Register of 2000. While Croatia has an adequate legal framework for registration, in practice many properties are not registered. This results from the failure to register or include on cadastre maps all the state- or enterprise-owned properties built during the socialist years, and more recently because of administrative delays, particularly in larger urban areas. For example, it is estimated that in Zagreb only about 50 percent of the properties are registered.

This problem is exacerbated by the manner in which registration of privatized apartments is regulated—all apartments in a building must be registered at the same time. In Zagreb, 90 percent of the population lives in privatized apartments. Banks will not consider making mortgages on properties that are not registered. There are also reports that the registration records are not accurate; in other words, even in cases where properties are registered, the records cannot be trusted. This problem has not been quantified.

To help address the problem of unregistered properties, the courts maintain Books of Deposited Contracts. This can be used for apartments in buildings that have not yet been registered but where the owner has a valid sales contract proving that he purchased the property. While this procedure does not afford the same legal protection as the land books or legal registers, and therefore banks will not accept it in lieu of registration of the collateral property. It does recognize the ownership status of the depositor and is often used for purposes buying and selling real estate.

Real property registration is managed by the municipal courts—The Croatian Geodetic Institute manages the property survey procedures and the real estate cadastre.

Tax Treatment of Transaction Fees and Mortgage Interest—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

While bank assets stretch out as far as 20 years, banks' HRK funding is principally short term, based mostly upon demand deposits and time deposits with maturities of one year or less. Some funding through parent bank loans also occurs. This maturity mismatch has several consequences, 2 of which are pertinent: 1) bank portfolios have an imbalance between liabilities and assets, and 2) insurance companies and pension funds are denied the opportunity to match their long-term obligations with long term financial investments such as mortgage-backed debt. Notably, however, several banks, including the fastest growing institutions, are actively considering asset sales/securitization, so the situation may ultimately change.

3.2 Capital Market Profile

The Government has made a conscious decision not to develop its domestic debt market, and to source most of its public debt abroad, where funds have generally been cheaper. As a result, most of Croatia's $7.2 in public debt is external and in hard currencies.

The domestic debt market consists almost entirely of Government securities. Domestic issues are mostly short term Euro-indexed but Kuna denominated floating notes. The $2.1 billion in domestic debt is in two parts: approximately USD $600 million in short -term paper, and $1.5 billion in special purpose instruments (such as frozen foreign exchange bonds, privatization 'big bonds', and "special issues" such as bank rehabilitation issues and health insurance organization issues). Pricing on these 'special issues' has typically been well above market; there have been sufficient quantities of "special" government paper (issued both at home and abroad) to discourage the emergence of market priced private debt issues, though a few corporate and municipal bonds have been issued. As noted, no mortgage bonds or MBS have yet been issued.

The Government of Croatia is free of constraints from international institutions (such as the IMF and World Bank), which would restrict government borrowing. As a result, the supply of government paper is quite elastic. (By contrast, countries such as Bulgaria and Serbia operate under tight constraint, which, when combined with pension reform (as in Bulgaria) leads to growing pressure from the capital markets to provide alternative sources of high-grade securities). This elasticity of supply does little to encourage the growth of mortgage-backed bonds.

Medium and long term HRK denominated paper is not currently available either from government or private issuers. There is currently some discussion regarding the Ministry of Finance extending the yield curve to include one year and longer issues, but no concrete plans now exist. (One 'exception' is the recent ten-year bond issue for the pension funds, which is Euro-denominated but settled in HRK).

The current secondary market infrastructure, by all accounts, is more than adequate to permit the growth of a market in MBS. There is an efficient, functioning stock exchange where bonds could be traded, and the Central Depository Agency has the technical capacity to ensure prompt and effective settlement of trades.

A corporate bond market has begun developing recently, but it is still in its infancy. A few commercial paper and longer-term issues have been launched, sold as private placements, mostly to the underwriting banks. All of the issues were either denominated in or indexed to the Euro. The main reason for the lackluster development of the corporate bond market is that Croatian corporations are accustomed to borrowing directly from banks, and the interest rates on corporate bank loans in Croatia are currently very low by historical standards. In most cases, the costs of doing an issue would outweigh the company's possible savings on the interest rate.

3.3 Bank Risk Management

At present, Croatian bank managers are not yet overly concerned with the maturity-matching dimension of risk management. Matching assets and liabilities, especially if it means the possible sacrifice of current profits for longer-term security, appear to hold little interest at present.

Banks have managed currency risk by indexing most loans—including mortgages—to the Euro. Although solid data are lacking, there would appear to be a pervasive mismatch of the maturities of assets and liabilities in the Croatian banking system, and an absence of regulations mandating this form of risk management.

As noted, while there appear to be no legal or regulatory barriers to issuing mortgage bonds, Croatian banks have demonstrated little current interest in selling their mortgages. There is currently no secondary market in Croatian mortgages, nor any other type of asset backed security. Banks consistently state that they have more than sufficient liquidity with which to satisfy consumer demand. The idea that 'turning' their portfolio could increase market share was not understood, nor that the sale of assets would increase shareholders' return on equity. Due to overall market conditions and increased competition amongst lenders, mortgage interest rates are falling. Thus, sale of their mortgage assets to generate additional cash and re-lend at lower rates is not a cost-effective option at present.

3.4 Potential Investors—Pension Funds and Insurance Companies

There is clear pressure on the demand side for new sources of high quality domestic securities with attractive yields. At the moment there is an excess of liquidity in the financial sector, with Government of Croatia bonds the principal product now available. Respondents indicated a clear desire to diversify into other products.

By far the biggest pool of liquidity is in the banking system. Assets in the banking system total about $20 billion. The largest source of securities remains the Government of Croatia (GoC). Yields on GoC paper are attractive, and banks participate freely in the purchase of externally issued GoC and Government Agency paper. Smaller banks, which represent approximately one third of banking assets, have considerable buying power, as do insurance companies. Assets in the insurance sector are less transparent, but substantial.

A growing, but still modest source of demand is from Croatia's seven licensed pension funds. Estimates vary of the purchasing power of the pension funds. Official (and optimistic) projections suggest accumulations at the rate of $350 million per annum. Estimates based on actual accumulation rates suggest an accumulation rate of $225 to $250 million this year, and $300 million in 2003. Investable funds may then total between USD $525 and 700 million within the next 18 months, and between $1.6 and $1.75 billion by the end of calendar 2006.

Pension fund managers have been increasingly vocal with respect to their need for products to purchase with their investable funds. However, the ability of Croatian pension funds to acquire MBS will depend upon the form in which they appear. The asset allocation rules detailed in the Pension Act will prevent, for the moment, the absorption of large issues from any single source. Up to 30 percent of a fund's assets can be invested in some combination of corporate and municipal bonds and local equities traded on the Zagreb Stock Exchange (Article 69, Act on Compulsory and Voluntary Pension Funds). However, the Pension Act restricts a fund from holding more than five percent (5 percent) of its assets in the securities of a single issuer. (Government securities are an exception). As one pension fund manager estimated, this means that this year the total pension fund absorptive capacity for a single issuer will be $12.9 million, or about $65 million over the next 5 years.

If Croatia follows the German model for mortgage bonds, pension funds will have limited capacity to absorb such bonds, due to the limited number of eligible issuers, and the 5 percent concentration limits imposed by the Pension Law. Alternatively, use of the US model permits greater flexibility with respect to issuing institutions (for instance, banks might devise strategies to permit greater absorption by the pension funds, such as sale of their mortgages to Special Purpose Vehicles). Under this scenario the absorptive capacity of the pension funds for MBS may be as large as $500 million, or 30 percent of the funds' assets. However, a cautionary note is in order, as none of these provisions of the Pension Act have been subject to either regulatory or court review.

It is not self-evident, furthermore, that the demand for new products will be sufficient to induce mortgage owners to securitize them.

3.5 National Bank and other Regulatory Policy Impacting Investor Rules

The Croatian National Bank imposes strict loan provisioning and reserve requirements. The National Bank is also increasingly concerned about the risks associated with the recent sharp increase in consumer lending; this puts into question the adequacy of the risk management policies of the banking sector, especially with regard to management of the potential duration gap emerging from a large volume of long-term mortgage loans.

The National Bank has also been reviewing the idea of revising loan loss provisioning requirements for rapidly growing banks. One possible effect of this might be to reverse the release of capital anticipated by several of Croatia's top banks under the new International Accounting Standard 39. Under this scenario asset sales become slightly more attractive.

Croatia has adopted the Basle Accord on capital adequacy, which is international best practice. Under these rules, mortgage loans on the bank's books are 50 percent risk weighted and must be backed by at least 4 percent in bank capital. Loans that are sold without recourse to the bank, on the other hand, require no capital allocation. Thus, sold and securitized loans enable the bank the take on more business with the same capital.

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.[10]

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

[10] 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 Cadastre Law of 1996, which provides for an integrated registry and cadastre. 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 cadastre, this is primarily an administrative problem that will be solved with time. The head of the cadastre expects the process of cadastre 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 cadastre. This is sufficient for the owner to obtain a cadastre number and to register the property in the legal registry. The cadastre 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 cadastre 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.

Mortgage Market Laws & Tools

Template for Mortgage Market Assessments

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