

LEGAL ISSUES FOR DEVELOPMENT OF THE MORTGAGE MARKET IN ARMENIA⁶

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Armenia's housing-finance system has grown rapidly along market-based principles, without direct government intervention. A growing number of commercial banks and a mortgage credit organization are actively engaged in the continued expansion and development of mortgage lending, and financial institutions founded just for the purpose of mortgage lending continue to enter the market. The paper argues that the basic legal framework for the primary mortgage market is quite strong, particularly compared to many other transition countries. In particular, it evaluates the recommendations of the working group appointed by the President of Armenia in 2004 to propose new laws and amendments to the legal framework for market finance.

I. OVERVIEW OF THE ARMENIAN MORTGAGE MARKET

The news about Armenia's mortgage market is good, from the standpoint of both the private and public sectors and for citizens who wish to purchase or improve homes. The housing-finance system is growing rapidly along market-based principles, without direct government intervention. A growing number of commercial banks and a mortgage credit organization are actively engaged in the continued expansion and development of mortgage lending, and financial institutions founded just for the purpose of mortgage lending continue to enter the market.

The presence of a "hot" real estate market in Yerevan is well-known, but throughout Armenia, in addition to the market for new home purchase or construction, there is an enormous market for housing renovation loans, particularly for privatized apartment-buildings. Owners of these buildings – now condominiums – usually have a large equity interest due to the low cost of privatization and the increasing value of real estate, at least in the larger population centers. With private home ownership at 98-99 percent in Armenia and high demand for upgrading, the potential for mortgage market growth is enormous.

⁶ The information in this report is based on a mortgage market Pre-feasibility Study in July 2004, updated where necessary with the results of a full Feasibility Study conducted in June 2005, just after the AIPRG Workshop in Tsakhkadzor. Both studies were conducted by the Urban Institute, under the auspices of KfW. The Pre-feasibility Study was accepted by the Government of Armenia in September 2004, and the Feasibility Study is currently under review.

From the public sector's standpoint, there is no resistance to growth of the mortgage market; rather, there is strong political and institutional support to get the essentials in place and to do it well.

II. BASICS OF THE LEGAL FRAMEWORK

The basic legal framework for the primary mortgage market is quite strong, particularly in comparison to many other transition countries. At present, it is adequate to support robust growth of mortgage lending activity. In particular, mortgage loan enforcement laws demonstrate effective reform and market-oriented initiatives. The areas of foreclosure and eviction have been stumbling blocks in many transition countries, but Armenia has largely surmounted them, both legally and politically. These laws remain untested, however, partly because of the positive credit culture among Armenians, who demonstrate a strong desire for home ownership and improvement, as well as a healthy commitment to paying debts. Of course, these attributes may be tested if there is an economic downturn or if mortgage lending becomes more widely available to people in middle-income or lower-middle income levels.

A working group to propose new laws and amendments to the legal framework for market finance was appointed by the President of Armenia in 2004. Members of the working group include representatives of the State Cadastre (the Chairman of the State Cadastre chairs the group), the Ministries of Finance, the Ministry of Justice, and the Central Bank. In the 2004 KfW Bankengruppe (KfW) Pre-feasibility Study, Urban Institute recommended numerous changes to improve existing laws. These recommendations were incorporated by the working group into new laws and amendments that were submitted to Parliament in June and passed on first reading in July 2005.⁷ The Feasibility Study (2005) includes additional recommendations to the working group for fine-tuning the legal framework for the primary market and longer-term suggestions and also outlines laws and amendments needed for developing a secondary market.

One longer-term weakness for the future development of the market is the lack of preparation for a secondary market. To help prepare for this, the Feasibility Study develops plans for loan standardization and quality assurance and provides legal and regulatory advice on how to prepare for sound operations of a liquidity facility and a market in mortgage-backed bonds and other securities.

⁷ The legislative package prepared by the Working Group and now under discussion in Parliament consists of the following proposed amendments and new laws:

- Amendments to the Civil Code;
- Amendments to the Law on State Registration of Property Rights;
- Amendments to the Law on Compulsory Enforcement of Court Decrees;
- Amendments to the Land Code;
- Amendments to Law on Apartment Building Management;
- Amendments to the Law on Licensing;
- Amendments to the Law on Administrative Regulations;
- Amendments to the Law on State Duties;
- Amendments to the Criminal Code;
- Law on Evaluation of Real Property (new);
- Repeal of the Housing Code of 1982.

III. ENABLING LAWS FOR MORTGAGE LENDING

Armenia has no mortgage law *per se*. The old Mortgage Law was abrogated by adoption of the Civil Code in 1999. The legal basis for the mortgage system is provided with comprehensive sections of the Civil Code, which cover ownership and other property interests and rights, including liens, the requisites for real property transactions, procedures for using property as collateral, and rules and procedures for a lender to seize and sell collateral in the event of default.

Titling and registration are covered in sound laws on registration of property rights, including mortgages, and resolutions on registration procedures.

IV. MARKET-ORIENTED ENFORCEMENT LAWS

A. Non-Judicial Foreclosure

Strong laws on enforcement of a lender's rights are critical to a robust mortgage system. Armenian law provides for non-judicial foreclosure – that is, if the loan documents are properly prepared, no court procedure is necessary for a lender to foreclose; however, the current law gives debtors almost unbridled rights to raise defenses in court against foreclosure after mortgage default. This countermines the intent and purpose of the Civil Code provision giving lenders the right to seize and sell mortgaged property without court intervention.

- *The working group has already made proactive proposals to Parliament to tighten these provisions and the rules on enforcement before they are implemented. These changes would place a high burden on debtors who wish to challenge foreclosure in court, by requiring a large security deposit and evidence of willingness to pay amounts due.*⁸

B. Sale of Property after Foreclosure

Similarly, there is a system for auction of the property after foreclosure that is not supervised by the court. The secured lender has first priority to the auction sale proceeds. Auctions can be burdensome, however, in terms of cost, time to complete, and uncertainty. The Pre-Feasibility Study recommended that lenders be permitted to conduct direct sales of property to third parties or on the open market after seizure for default.

- *The working group has proposed amendments to the current law to allow a creditor to sell property directly to third parties following foreclosure, as long as proper notice is provided and a fair price is set.*⁹

⁸ These amendments are to the Civil Code (effective Jan. 1, 1999), article 249, and the Law on Compulsory Enforcement of Court Decrees (1998), Article 22.

⁹ This provision is included in amendments to Article 249 of the Civil Code. Because it allows a bank to sell real estate directly, this amendment to the Civil Code may require an amendment to the Law on Banks and Banking Activities (1996), or at least a new Central Bank regulation giving banks the necessary authority to sell property. Article 34 of the Law on Banks and Banking Activities enumerates activities in which banks are permitted to engage, which not include sales of property. Article 34 further provides that “banks shall be prohibited to implement industrial, trade and insurance activities if the law does not provide otherwise.” Even

C. Eviction

The market value of a property after foreclosure would be seriously diminished if it is occupied, particularly if the occupant is a disgruntled debtor. The right to evict after foreclosure is provided in the Civil Code if the debtor has not vacated within 30 days. There are currently certain exceptions to this rule, relating to occupancy rights of family members of the debtor, provided in the 1982 Housing Code, which largely reflects policies from socialist days.

- *Amendments to the Civil Code have been proposed to Parliament by the working group to tighten the eviction procedures and to repeal the entire Housing Code.¹⁰ The proposed amendments call for the owner (the debtor) to pay compensation to occupants with registered rights, but the occupants may not use the issue of compensation as a defense to eviction.*

D. Bankruptcy

Bankruptcy does not protect a debtor from foreclosure. There is no bankruptcy protection for natural persons under Armenian law. Even in the case of bankruptcy of a legal person or the sole proprietor of a business, mortgaged residential property is excluded from the bankruptcy estate and the secured creditor may proceed with foreclosure against the insolvent debtor.

- *There are no proposed changes to bankruptcy law or bankruptcy provisions in the Civil Code.*

E. Confidence in the System

Lenders demonstrate their high level of confidence in the enforcement laws by their use of the mortgage itself as the primary collateral for a housing loan. Many other transition countries require a complex system of “belts and suspenders” to protect them from mortgage default. These include multiple third-party guarantees, an authorized salary pledge, which allows automatic attachment of wages of the borrower and guarantors in case of default, pledge of additional real property, deposit accounts, and even bills of exchange. Armenian bankers typically require none of these extraordinary forms of security and seemed surprised at the very idea; they regard conservative underwriting of the borrower’s ability to pay and appraisal of the property value as considered adequate safeguards.

One caveat to this positive assessment: the laws are strong and will be stronger if the new amendments are adopted, but they are largely untested. Mortgage lending has grown rapidly just in the last year or two, and most lenders have experienced no defaults to date. There is confidence that the judiciary will enforce creditors’ rights in court in the event that

if property is sold by a real estate broker after seizure, the broker would be acting as an agent on behalf of the bank, which may not be sufficient to overcome the prohibition against trade in the law on Banks and Banking Activities.

¹⁰ These changes appear in amendments to Article 272 of the Civil Code. The repeal of the Housing Code is by separate law.

debtors raise defenses, but only time will tell how effectively the laws work and how long the process of foreclosure and sale of collateral will take.

V. WORKING GROUP AMENDMENTS TO OTHER LAWS

A. New Right of Construction

A proposed amendment to Civil Code creates a new property interest – the right of construction. This right may be mortgaged, and may be granted by the owner of a land plot for a term of up to 99 years. This change should lead to greater availability of construction finance.¹¹ The right is acquired by law, or by contract between the parties.

B. Unification of Condominium Real Estate

New amendments have been introduced to the Law on Apartment Building Management to clarify the apartment owners' rights to the land plot as well as the common property of the apartment building. These require that an owner who sells, donates, exchanges or pledges his apartment must do so together with his share of the common property of the building and his share of the land, which form a unified parcel of real estate.¹² These amendments are consistent with common legal practice relating to ownership and registration of condominiums throughout the world.

In Armenia, since the land plots were not initially transferred to owners of privatized apartments, this clarification was needed. Land plots will now be registered as part of the common property that is owned by shares by the owners of apartments, along with the common property included in the apartment building itself (the hallways, roof, mechanical systems, etc.). The owner's title will specify the ownership share of the land and the building, as well as the individually owned apartment. The amendment will clarify that the unified parcel of real estate will be pledged or transferred together.

C. Mortgage of Property with Unauthorized Construction

Under the current Civil Code and Law on Registration of Real Property, a lender cannot legally transfer property to a buyer after foreclosure if there is illegal or unauthorized construction on the property. In most cases, unauthorized construction is something built on a property without a proper permit or in violation of the terms of the permit or normative building standards. Unauthorized construction may be something as simple as new windows on a house or construction of a garden shed on a land plot, so this provision affects a substantial number of properties in Armenia.

Currently, to issue good title, the construction must either be “legalized” or demolished. Legalizing the construction so that the cadastre can be corrected and the property

¹¹ These amendments appear in the Civil Code, Articles 170, 204 and 267-1, and the Law on State Registration of Rights over Property (1999), Article 30-1.

¹² The changes appear in the Law on Apartment Building Management (2002), in Article 7, with conforming provisions in the Law on State Registration of Rights over Property, Articles 36 and 40, and the Civil Code, Article 224.

transferred may require a court procedure. In the best case, it is a slow and uncertain process because of the need to acquire a *post-facto* building permit from the municipality, undergo inspection by the municipality and the cadastre, and re-register the property.

A proposed amendment to the Civil Code allows the cadastre to issue new title to a buyer or other transferee of property upon which there has been unauthorized construction.¹³ The procedure will be to issue a drawing of the plot that indicates the unauthorized construction through use of a different color or lines around the unauthorized object. Proposed procedures for registration of property with unauthorized construction should be published as soon as possible, so the cadastre can begin to implement the new amendments as soon as they are passed.

D. Sale of State Owned Land

Under current law, state-owned land may not be sold or otherwise transferred to a new owner. When land is leased from the state and a building is constructed, the land remains in the ownership of the state.

Additions and amendments to the Land Code of Armenia (2001), the Civil Code, and the Law on Registration of Rights over Property have been proposed to clarify the tenure rights to land upon which a building has been constructed and to allow for the sale or transfer of state-owned land for development.¹⁴ Under the amendments, a developer has several possibilities for using state-owned land as collateral for a mortgage: the developer can acquire a right of construction through a public tender (if the land is deemed to be important for a public purpose) or it can purchase the land outright and mortgage the land and future construction.

E. Mortgage over Future Construction on Mortgaged Land

An amendment to the Civil Code states that a pledgor may construct on a pledged plot of land without the consent of the pledgee, unless otherwise provided for in the contract of mortgage, and that the right of pledge then applies by force of law to buildings or structures built after the mortgage loan is made.¹⁵ Previously, the Civil Code provided in that mortgages over land plots would be secured only by “incomplete construction and materials and equipment prepared for construction belong to the pledgor.” The amendment will facilitate mortgage of land subject to development.

¹³ Amendment to Article 188 of the Civil Code.

¹⁴ The proposed amendment changes Article 188 of the Civil Code. Article 188 refers to the Law on State Registration of Rights over Property for rules and procedure for the cadastre to use for registration or transfer of registration of property with unauthorized construction. At the present time, the proposed amendments to the Law on State Registration of Rights over Property do not include procedures for this type of registration.

¹⁵ Amends Article 267 of the Civil Code.

VI. TAXATION AND FEES

Taxation and fees relating to mortgage transactions present no impediment to the growth of the mortgage market. Bank fees for mortgage lending are low – about US\$100, including origination, documentation, registration, and notary fees.

A word on fiscal policy relating to mortgages: there is no deduction for interest paid on mortgage loans, and interest on savings and dividends is taxed. While this is good fiscal policy, some other carefully targeted incentives might be considered to encourage long-term savings, investment in mortgage bonds, or to increase financial sector intermediation among underserved sectors of the population.

VII. AUXILIARY MORTGAGE MARKET ACTIVITIES

A. Realtors and Appraisers

Realtors and appraisers are quite well organized and professional in Armenia, although there is no multiple-listing service. Banks often rely on their own in-house or contracted appraisers so they are confident of evaluation for loan purposes. Currently, no law governs the activities of appraisers.

- *The working group has proposed a new Law on Evaluation of Real Property. This law will regulate certification of appraisers, and requires that international standards be used in the appraisal process. The proposed law provides that appraisals in compliance with the law are mandatory in cases of sale of real estate after seizure.*

B. Insurance

One gap in the existing framework that working group did not address is the insurance sector. The entire sector is inadequately developed and regulated, and no insurance of any kind is required by law – not even automobile insurance. Estimates are that only one to two percent of the population participates in any manner in the insurance sector. Requirements for property and life insurance vary among mortgage lenders, some require none, and few require life insurance. Life and disability insurance are not readily available. There is no insurance for construction delays or for mortgage default.

The KfW reports recommend that banks require at least property and life insurance for mortgage loans as a matter of good business practice. Such a requirement should also be part of the regulation for standardized loans qualified to back bonds or other securities. This issue will be addressed through development of minimum quality standards as part of ongoing work by KfW in the mortgage sector in Armenia.

Deposit Insurance

There is a new deposit insurance program that took effect in Armenia in July. The hope is that this will encourage larger and longer-term savings; however, the coverage caps are fairly low so it is unclear if this will help provide longer terms deposits to help fund mortgages with longer terms.

C. Notaries

The Civil Code requires all contracts and transactions in real estate to be prepared by a certified notary. Notaries are now private in Armenia. They are reasonably priced and regarded as highly reliable. They are regulated and certified by the Ministry of Justice. No changes to the system of notaries has been proposed or recommended.

D. Enforcement Officers

Enforcement officers carry out mortgage lien rights relating to foreclosure and eviction, and collection of additional collateral from debtors if the sale-proceeds of the property do not cover the full debt. They are employed and regulated by the Ministry of Justice and are regarded as reliable, despite the fact that they are poorly paid.

E. Credit Bureau and Mortgage Reporting

Credit bureau activity is underway, both in the private sector and at the CBA.

The 2004 Pre-Feasibility Study recommended that credit reporting be refined to segregate mortgage loan reporting. The CBA adopted this recommendation and now requires data on size and number of mortgage loans from each reporting institution.

VIII. RELEVANCE OF PRIMARY MARKET LAWS TO A SECONDARY MARKET

The laws discussed above are important not only for development of the primary market for mortgage lending, but also for the future participation of mortgage loans in the capital market. Investors and rating agencies look to security of title and liens, the history of loan performance, and the success and speed of loan enforcement to determine the quality and value of mortgage-backed bonds or other securities. This is a standard part of investor due diligence.

The bottom line on preparation for the secondary market is that without strong deterrents to default and predictable access to collateral if default occurs, mortgages will effectively be locked out of the secondary market.

IX. PREPARATION FOR A LEGAL FRAMEWORK FOR THE SECONDARY MARKET

Many mortgage lenders express interest in developing a secondary market for mortgage loans, but they are not pushing for this. At the present time, access to funding is adequate and affordable, but as term lengths increase for mortgage loans, longer term funding may become more desirable.

There is apparently a market in Armenia for purchasing mortgage bonds, if properly regulated, since other options for investments in bonds are limited. It is useful to note the experience of other transition countries, where mortgage bonds are flourishing, particularly in Central Europe. In recent years, Hungary, Czech Republic, Slovakia, Poland, and Bulgaria have issued in the aggregate over Euro 8 billion in covered mortgage bonds.

A. KfW Mortgage Loan Refinancing

KfW expects to initiative mortgage loan re-financing in 2006, through a liquidity “window” financed by the German-Armenian Fund. Recommendations for the design and operations of the liquidity facility are described in Urban Institute’s Feasibility Study. In addition to the refinancing activity, KfW will contract for technical assistance and training, particularly in the areas of loan underwriting and servicing, and implementation of Minimum Quality Standards acceptable to the CBA and individual participating banks. These activities will help strengthen the primary market and pave the way to the secondary market.

B. Necessary Laws and Regulations for Secondary Market

Revisions to existing law and regulations and perhaps a separate new Law on Mortgage and Mortgage Securities will probably be necessary to guide the development of a secondary mortgage market in Armenia.

In addition, several kinds of regulation are necessary to regulate the issuers of mortgage-backed securities, on coverage requirements, reserve and capital treatment, and insolvency, and to regulate the operation, supervision, taxation, and registration of secondary market transactions.

The following factors must be considered:

- Framework for selling mortgage portfolios and individual loans;
- Procedures and costs of registering transfer of mortgage interests or other financial instruments;
- Rules for emission and circulation of mortgage-backed bonds;
- Legal choices among covered bonds or asset backed securities;
- Legal entities involved in secondary market;
- Banking Law issues;
- Securities Law issues;
- Bankruptcy Law issues, as they affect secured creditors, mortgage creditors and holders of asset backed securities;
- Regulated investors (pension funds, insurance companies and others); and
- Taxation of entities, financial transactions, and financial instruments.

These issues are analyzed in detail in the “Legal Report and Advice to Counterparts,” prepared as a separate document as part of the Feasibility Study by Carol S. Rabenhorst and Stephen B. Butler (July 2005).¹⁶

¹⁶ Copies are available through the Urban Institute. Contact Carol Rabenhorst, csrabenh@ui.urban.org.