Instruments to Develop Fully Integrated Primary and Secondary Market in Housing Finance in Armenia

Dr. Friedemann Roy, Senior Project Manager, Bankakademie International

This article summarizes a presentation given at the AIPRG Workshop on Financial Sector Reforms in Tsakhkadzor on May 29, 2005. The presentation was aimed at laying out some of the topics of the Feasibility Study on the Armenian housing finance market commissioned by KfW and conducted by Urban Institute and Bankakademie International.

I. Introduction

The housing finance sector in Armenia is steadily improving. Armenians can increasingly acquire better housing through tapping into formal sector credit. This will not only mean improvements in the size and quality of newly purchased flats but more rapid upgrading of existing flats and houses, a more dynamic private construction market, and profitable, relatively low-risk sector for growth in bank lending and potential for capital market activities.

The Armenian government fully supports this development and has therefore requested Kreditanstalt für Wiederaufbau (KfW) to take the lead among donors in the joint development of this sector, including fully integrated primary and secondary housing finance markets. This article summarizes a presentation given at the AIPRG Workshop on Financial Sector Reforms in Tsakhkadzor on May 29, 2005. The presentation was aimed at laying out some of the topics of the Feasibility Study on the Armenian housing finance market commissioned by KfW and conducted by the Urban Institute and Bankakademie International.

The article is organized in the following way: first, it highlights the rationale of Minimum Quality Standards in Mortgage Lending (MQS) and their importance for primary and secondary markets; second, it discusses the potential of contractual savings schemes for housing (CSSH) as complementary funding tool; and finally, it provides some reflections on the establishment of a training program in housing finance for Armenian lenders.

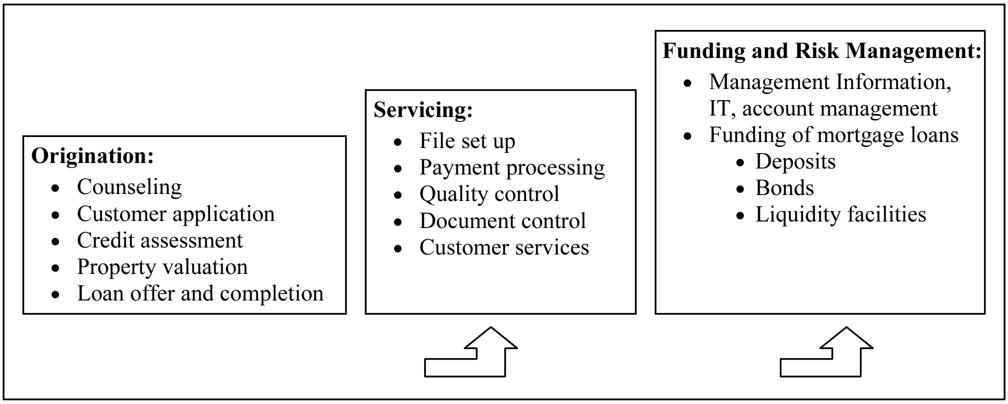
II. Establishment of MQS in Mortgage Lending

The Armenian government supports the development of fully integrated primary and secondary markets. What does this term mean? It means that borrowers that want to take up a loan will seek financing at their banks. In fully integrated markets, banks are able to outsource tasks to specialized entities that would typically carry it out themselves. These tasks comprise origination, servicing, risk management and funding of the mortgage loans. With the appearance of a secondary market, for example, banks can look for refinancing of their mortgage loans portfolios through that market, either directly tapping the capital market or through a working secondary market operator. In either case, the cost of such funds will depend on the quality of the loans being made in the primary market.[22]

The quality of the primary market depends on several elements, but none more so than the quality and consistency of the underwriting standards being used and the servicing being done after origination. When investors are being asked to place their trust in the loans as backing for securities, the minimum standards in these regards become critical.[23] Thus, the main function of MQS lies in the setting of standards in all areas of the mortgage lending process, including loan origination, servicing, and risk management. MQS are standards in underwriting, documentation, administration and data collection. They are aimed at establishing effective and efficient mortgage lending procedures and improving the risk management of mortgage loan portfolios. Standardized processing of mortgage loans facilitates their inclusion in mortgage bond or mortgage-backed securities issues.

Ideally, the MQS Manual would be structured along the value chain of the mortgage lending process as shown in figure 6.1.

Figure 6.1. Proposed Structure of Minimum Standards in Mortgage Lending (MQS)



Typically, a mortgage loan is processed in three steps: origination, servicing and funding and risk management. These steps represent the value chain of the mortgage lending process.

The origination process is the first contact with the borrower and furthers steps to reach the loan agreement. During this period, the bank gathers as much information as possible about the financial situation of the borrower and the value of the property being offered as

22 Functioning legislation and a stable banking sector would be a further prerequisite.

23 See EBRD, Mortgage Loan Minimum Standards Manual, April 2004, page V and Banking Methodology and Analyses Department of CBA, Methodical Guidelines on Mortgage Lending by Banks (Credit Organization), Yerevan 2004, page 3.

security. The results of this assessment are laid down in the loan application and are the basis for the final decision on the borrower's request for a mortgage loan.

The servicing process is aimed at organizing efficient documentation and processing of the mortgage loan data (information provided by borrower, the appraiser, etc.), thus allowing for adequate quality control. Furthermore, it facilitates the monitoring process. An additional goal of the servicing process is to provide good service to the customer. The quality of the servicing mainly depends on the quality of the lender's IT programs.

The risk management and funding process consists of two elements: first, it comprises the management of the mortgage loan portfolios in a way that related risks are minimized (*e.g.* concentration risk, interest rate risk, liquidity risk, etc.). Second, the funding should correspond to the outstanding loan portfolios in terms of maturities, spreads, etc. (within the context of the overall portfolio of the lender).

Following the mortgage lending process, the MQS Manual is organized in the following way: the first section defines the necessary steps during the origination process (as illustrated in figure 6.1). The second section lays down the procedures and processes during the servicing process. The last section explains the necessary steps for adequate risk management and funding of the mortgage loans.[24]

A successful application of MQS in Armenia requires, however, broad acceptance within the financial community. For that reason, the goal of the consulting team, organized during fieldwork discussion rounds for all Armenian lenders to win their joint support and assistance, is to draft MQS that take into consideration the Armenian context and to deduce the recommendations necessary to improve the lending standards applied by the lenders. As a further prerequisite, good co-ordination and interaction between the supervisory bodies and the lenders would be crucial to facilitate a smooth introduction of MQS. This process may also lead to amendments in the legislative framework for mortgage lending.

As a result, MQS assist in improving the transparency of mortgage-loan products for customers, creating interest in the product. MQS make it easier for customers to gather and to compare information about the different product various banks offer to them. Lenders would benefit from MQS as well because they facilitate not only the processing of mortgage loans, but also the long-term funding of the loans in the primary and secondary market. If lenders can combine lower funding costs from a higher degree in standardization of the loan business with more dedicated service, they are poised to achieve a competitive edge over their competitors.

As a result, the MQS Manual is aimed at laying out the foundation for standards in the mortgage loan process; however, the standards are not a binding regulation imposed on the lenders by any governmental entity. Rather, they are a voluntary code. Lenders can still pursue their own lending policy (which offers room for market differentiation and competition). Such loans would not be eligible for refinancing by the planned refinancing facility of mortgage loans of KfW, because the inclusion of the MQS Manual is a prerequisite for participation in this scheme.

[24] A complete version of the MQS Manual can be obtained from the author of this article.

The MQS Manual presented to the Armenian financial community is a product of the Armenian lenders. The Consulting Team only facilitated the discussions to produce these guidelines. The current Manual is not intended to be definitive; no doubt there will be further improvements to mortgage lending practices as lenders further develop this business.

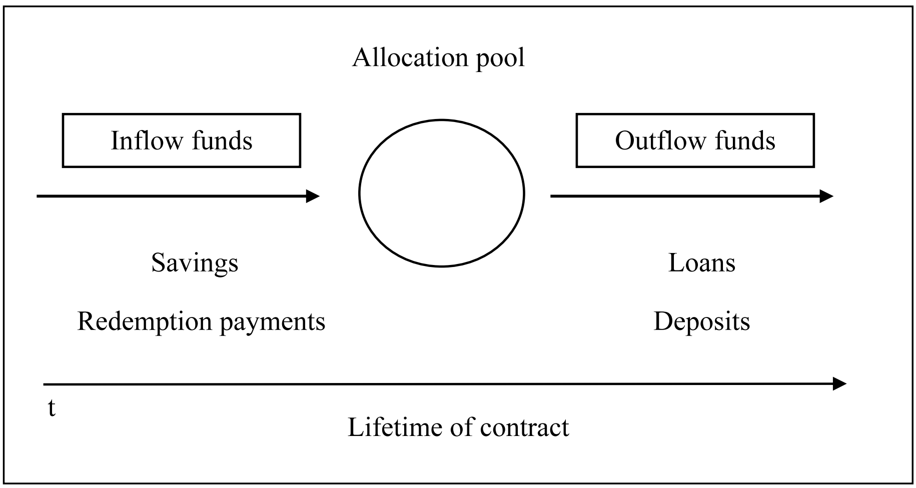
III. THE POTENTIAL FOR CONTRACTUAL SAVINGS SCHEMES FOR HOUSING IN ARMENIA

Contractual savings schemes for housing (CSSH) could be a further element of a fully integrated primary market. CSSH are one of the simplest and oldest funding mechanisms in housing finance. Typically, they link a savings period to the promise of a housing loan, which is fixed at a rate below the market level at the time of the conclusion of the CSSH-contract. Mainly two forms of CSSH have emerged:

- **Closed system:** funding of CSSH loans exclusively relies on savings funds previously collected by the CSSH institution.
- **Open system:** external funding is permitted when the inflow of savings does not suffice to meet the loan commitments of the CSSH institution.

In both systems, the underlying construction of the CSSH product is more or less identical: it starts with a savings period, in which the saver is required to regularly save, eventually accumulating about 50 percent of the previously agreed contract sum. Subsequently, he is entitled to a loan offer. The CSSH loan, which is made up of the remaining balance between the contract amount and the amount saved, will be paid out to the customer together with his savings. Especially in a closed system, the disbursement of the CSSH loan may be deferred unless there are enough funds in the savings collective. Thus, the customer may be subject to a waiting period. During the loan period, the customer repays his CSSH loan in regular installments. Figure 6.2 shows the mechanics of CSSH systems.

Figure 6.2. Mechanics of CSSH Systems



The introduction of CSSH is associated with the following risks:

- **Economic view:** The concept of the closed CSSH system makes external funding less relevant; however, overall market conditions influence fund supply and loan demand. Especially in a volatile environment, a cash shortfall is likely and may lead to unsustainable waiting periods. Hence, most countries which have introduced CSSH have applied strict laws and introduced tight supervision (usually through the central bank) to ensure the stability of the CSSH pool and the managing institution.

- **Banking view:** CSSH requires consumers to trust banks, because they are asked to commit themselves to longer savings terms than they were previously accustomed to. Therefore, the institutional set-up as well as the protection of the savings is crucial to sustainable CSSH in an economy. Faltering schemes may have deteriorating repercussions for the whole banking sector.

- **Risk management view:** Two risks are prominent in this regard:
  - **Liquidity risk:** The key risk of a closed CSSH is liquidity risk, or the risk that banks will have insufficient low-rate funds in the scheme to meet future loan demands. Therefore, aggregate liquidity management crucially depends on whether products are individually viable and how credible the scheme is as a generator of loans. The latter implies ensuring a sufficient ratio of loan allocations within the collective.[25] As a result, contractual loan-to-savings multipliers cannot exceed certain prudential values.
  - **Interest-rate risk:** In a closed system, interest rate risk is limited by contract design; however, pricing of the contract must take into consideration capital market movements. If interest rates on the savings and the loans do not anticipate future market developments, attracting savings or selling loans may become difficult.

- **Government view:** The choice of CSSH schemes as a housing policy instrument worthy of special support has been controversial.[26] It is our recommendation; therefore, that the responsible legislative bodies of Armenia should emphasize the functionality of CSSH, *i.e.*, prudent legislation and tight monitoring of CSSH should be an unconditional prerequisite for their implementation.

  Direct support in the form of a savings bonus would require a profound and distinct policy debate, since the government has not yet considered whether to subsidize housing finance. Direct subsidies for a CSSH system may induce further subsidy claims on the government and lead to distortions in the housing market as well as a severe burden on the state budget.[27]

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[25] As a result, contractual loan-to-savings multipliers cannot exceed certain prudential values. Since CSSH have not yet been established in Armenia, the multiplier should not be higher than 1 in the initial, set-up phase. Albeit fundamental, this advice is nevertheless often violated in inflationary environments when no additional measures have been taken to preserve the real value of savings. The consequence is a severe rationing of willing loan-takers through the imposition of waiting periods or, in the cases where this is legally impossible, by conversion into an open system with interest rate risk. In the extreme form, the system accumulates a large number of fixed-rate loan claims and becomes insolvent and/or illiquid.

[26] See D. Diamond, "Do Bausparkassen Make Sense in Transition Countries?" European Mortgage Review, Issue No. 21, Council of Mortgage Lenders, London, 1999.

[27] Some countries in Central and Eastern Europe (like the Czech Republic and Hungary) introduced extensive subsidy schemes of various forms and sizes in order to promote housing. As a consequence, these countries

The concept of CSSH implies the following benefits:

- **Economic view:** An attractive design may induce consumers to save since the favorable conditions of the loan promised may be viewed as an effective incentive. It may be also of interest for those groups that mainly rely on formal, though unreported, incomes. As a result, these funds will be channeled back into the formal banking sector to be utilized for financing investments in the country.
- **Banking view:** Armenian banks see the scheme as particularly applicable to modest loans for home improvement or for complementing other mortgage loans. The final outcome largely depends on the individual and regulatory structure of the CSSH product. Banks may also use this product to expand their customer base and to deepen the existing one. [28]
- **Risk management view:** Due to the pre-savings requirement, a high number of defaulting loans are unlikely. Default rates of the Bausparkassen amount in Germany to 0.03 percent of the total loan portfolio and in Slovakia to 0.56 percent (data as per December 2003). In Armenia, the pre-savings argument may be very valuable for those clients who have not yet established a credit history, thus allowing banks to use CSSH as pre-screening instrument indicating future reliable borrowers.
- **Government view:** CSSH may be useful to improve low and middle-income groups' access to credit since they could save into creditworthiness. This savings record serves as a replacement for lacking credit history. Therefore, CSSH can be regarded as a tool in Armenia to reach groups, which so far have little or no access to credit.

The case for CSSH is strongest when considering its use outside the standard mortgage market. CSSH offers generally small volume loans, which are often not collateralized by mortgages and, therefore, are costly to securitize.[29] According to the Consulting Team's assessment in the Feasibility Study, CSSH loans may be an attractive instrument to finance renovation and modernization in Armenia. Since there is a high demand for housing improvements in Armenia, CSSH may offer to households a lower-cost alternative to consumer loans on offer currently for these purposes.

IV. TRAINING PROGRAMS IN MORTGAGE LENDING

An organized and systematic approach to bank and financial services professionalization in Armenia is slowly arising. To date, there are no special training courses in housing finance. The main providers of bank training-courses are the Central Bank of Armenia's (CBA) training centre and Financial Banking College Foundation (FBCF).

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suffer from a distorted housing sector and higher budget deficits (especially Hungary). For further information, see A. Dobricza, "Home Finance Subsidies in Hungary", Housing Finance International, December 2004; H.-J. Dübel, "Wohnbauförderung in Mitteleuropa", BWV Berliner Wissenschafts-Verlag, Berlin, 2004.

[28] Surveys in Germany have shown that bauspar customers have purchased at least two other bank products in comparison with non-bauspar clients.

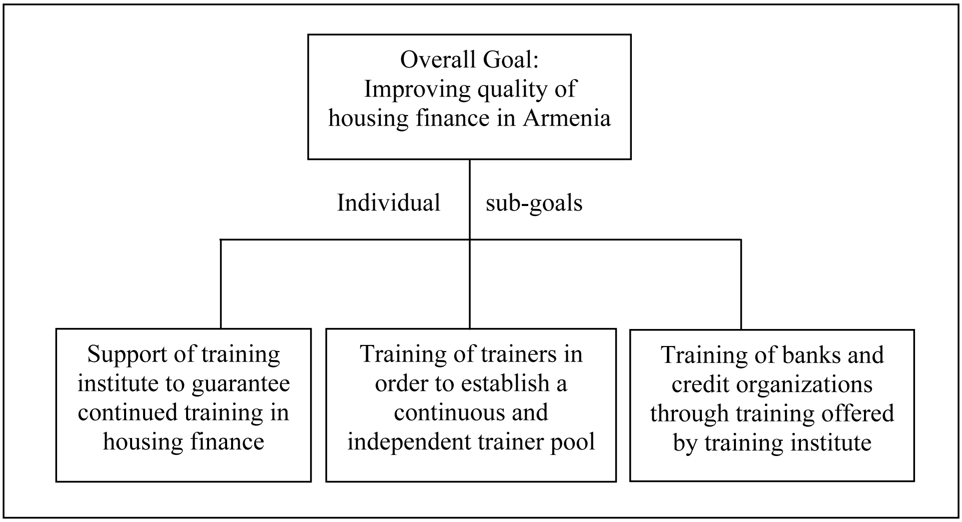
[29] In the Czech Republic and Slovakia, 70-80 percent of loans are not collateralised and are given on a personal guarantee basis.

With the risks and developments in the banking sector and in housing finance, in particular, higher demand for training is bound to emerge in the next years. Hence, all lenders would benefit from a more coordinated approach to technical, financial, and management training.

Due to the particularities of housing-finance products, the need for special training in this area is likely to increase as more financial institutions decide to enter into this sector of the market. They are expected to express a desire to better understand the risks implied and the prerequisites for sound risk management and successful product development strategies.

Training can be defined as the process to convey knowledge of a certain subject in an organized and structured manner. It encompasses both theoretical components and practical elements (*e.g.* case studies). Participants in training, by the end of their course, have acquired certain know-how in a specific area or topic (*e.g.* housing finance).

Figure 6.3. Objectives of Training in Housing



According to figure 6.3, a training concept could comprise the following elements:

- An institution with recognized standards should be in charge of the training courses so that training can be offered on a sustainable basis. This institute should possess appropriate equipment to facilitate the learning process.
- Any training program should emphasize the training of trainers (preferably local) so that the programs become independent of external help, and the training institute can ensure its continuity.
- The training should serve to qualify staff to do a better job and to provide better service to the customers. Therefore, it should focus on practical experiences, case studies and interactive teaching. Moreover, it should adapt to changing needs of the financial community.

A training course for Armenian lenders should consist of the following components:

- A general overview of housing finance systems and funding mechanisms of mortgage loans in other countries. The course would focus on forms and methods of residential lending in developed countries and transition countries as well as funding mechanisms (CSSH, mortgage bonds, mortgage-backed securities, housing market dynamics, etc.)
- Mortgage instruments. The study of different types of loan instruments could be a topic of interest to the lenders (*i.e.* fixed rated mortgage, adjusted rated mortgages etc.).
- An understanding of the legal conditions and relevant laws in mortgage lending. This would serve the strong desire to better gauge legal consequences and the underlying legal framework in mortgage lending (in particular the concept of a mortgage, transfer to ownership, contractual procedures, foreclosure etc.).
- Analysis of creditworthiness of customers. A training course should encompass concepts and procedures of underwriting and its components related to the evaluation of borrower's paying capacity (in particular calculation of the ability to repay), and availability of fund for down payment and transaction cost. In addition, more information about evaluation of the collateral property and title verification could be of great value to the lenders.
- Risk management of mortgage loan portfolios. International approaches of risk-management techniques in mortgage lending would be a valuable component: how do they address credit risk, interest rate risk, liquidity risk, prepayment risk, exchange rate risk, inflation risks etc.?
- Pricing mortgage loans. The course should include training on not only cost of funds, operating cost, risk spread, and profit, but also methods for calculating bank's operating cost and for annual planning revenues from lending activities could be of importance in such a course.
- Delinquency management. Topics of interest would include how better to identify delinquent borrowers, measures to help borrowers in arrears, legal foreclosure procedures etc.
- Communication with the customers. Improving the communication skills of bank staff is relevant. Areas of interest include how to conduct interviews with customers (over the counter and on the phone), questioning techniques, conflict-solving mechanisms etc.
- Planning mortgage operations in a bank. Those lenders that have not yet entered the mortgage market may ask for basic methodological approaches to business planning and main components and techniques in drafting a business plan for their mortgage department. In this regard, software programs for mortgage operations are also of interest to the banks.

In any case, the planned course should not be just mere theoretical lectures. They should include practical training (wherever it is applicable). This objective can be achieved through case studies, simulations of counseling interviews (as an example) or adequate software models.

Training programs will assist financial institutions in providing better service to their customers and improving the risk management of their mortgage portfolios. In addition, better-trained staff is likely to sell more products, thus generating higher profits. As a result, the risk management in the financial sector, as a whole, would improve and would be more resilient to macroeconomic shocks.

V. CONCLUSION

Supported by favorable macroeconomic conditions and continued strengthening of the banking sector, the mortgage market in Armenia is growing quickly. The stock of loans is estimated by the CBA to have risen 154 percent during 2003 and another 70 percent in 2004, to about US $13 million as of April 2005. This growth is related to changing terms on offer as well growing acceptance of the idea of borrowing for housing.

In the near term, the level of competition in the sector is set to rise significantly. With this competition and rising consumer demand, it seems likely that rates will consolidate in the 12-14 percent range and perhaps decline further to the range of 10 percent as margins shrink. But more important for the evolution of the market is the maximum term. Some banks already offer mortgage loans bearing terms up to seven years. The continuing stabilization of the country is likely to favor even longer terms in the near to mid-term future.

This article proposes measures that would support primary and secondary market development in Armenia. A specific training program in housing finance would be a suitable measure to enhance the quality of service to customers and to improve the risk management capabilities of the lenders. Moreover, it could be used as a tool to attract talented individuals who seek a career in banking.

CSSH has the potential to move the market further downwards and to open the market to low and middle income groups, which often have no access to credit due to a lack of credit history; however, the concept and institutional set-up requires careful study of the overall market conditions to avoid any pitfalls after the introduction of CSSH. Tight regulation and supervision would be one measure to maintain stability and to build up confidence in the system.

MQS define standards in origination, servicing, and risk management and funding of mortgage loans. They lay the foundation for well-balanced mortgage loan portfolios and efficient processing of mortgage loans. As a result, they imply the path to lower-cost funding and more dedicated customer services. Those banks that intend to securitize their mortgage loan portfolios will benefit from these standards since they could meet information requirements of potential investors in a quick and adequate way.

The three instruments described in the article would, therefore, constitute decisive steps to prepare for fully integrated primary and secondary markets in Armenia. Additional measures could consist of revising the legislation relevant to housing finance and the institutional design of secondary mortgage operators. In this regard, the market could experience a further boost by supporting the set-up of insurance companies that are prepared to assume risks related to housing finance operations from banks and individuals.