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Formation of the Mortgage Bond Market in Latvia

By Rolands Panko

Mortgage and Land Bank of Latvia

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Mortgage Bond Legislation

- Law on Mortgage Bonds
- Civil Law
- Law on Land Books
- Law on Civil Process
- Law on Credit Institutions
- Law on Securities

Developments in Mortgage Bond Legislation

- **Law on Mortgage Bonds**
  - loan amount together with debts previously entered in Land Books may not exceed 75% of the market value of real estate used for permanent living throughout the year, and 60% of the market value of other types of real estate

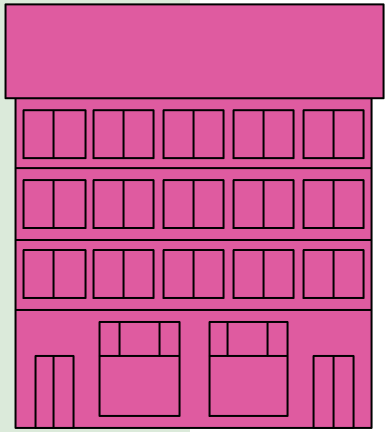
Developments in Mortgage Bond Legislation

- **Law on Land Books**
  - the section on the computerised (electronic) Land Book has taken effect thus allowing any person obtain information on real estate concerned due to the linkage of all Land Books in a common network

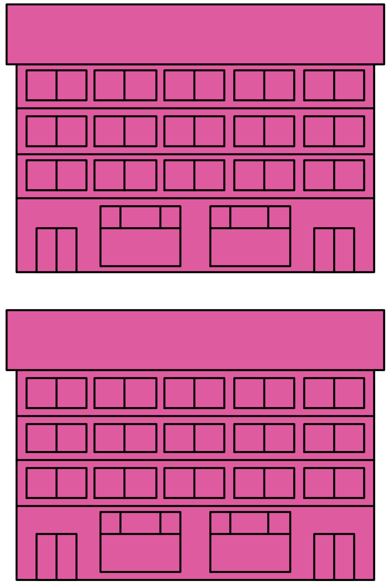
Developments in Mortgage Bond Legislation

- **Law on Credit Institutions**
  - common supervision of the finance and capital market that combines the supervisory function of credit institutions, insurance companies and the participants of the securities market

Pure Mortgage Bank v.s. Mixed Mortgage Bank

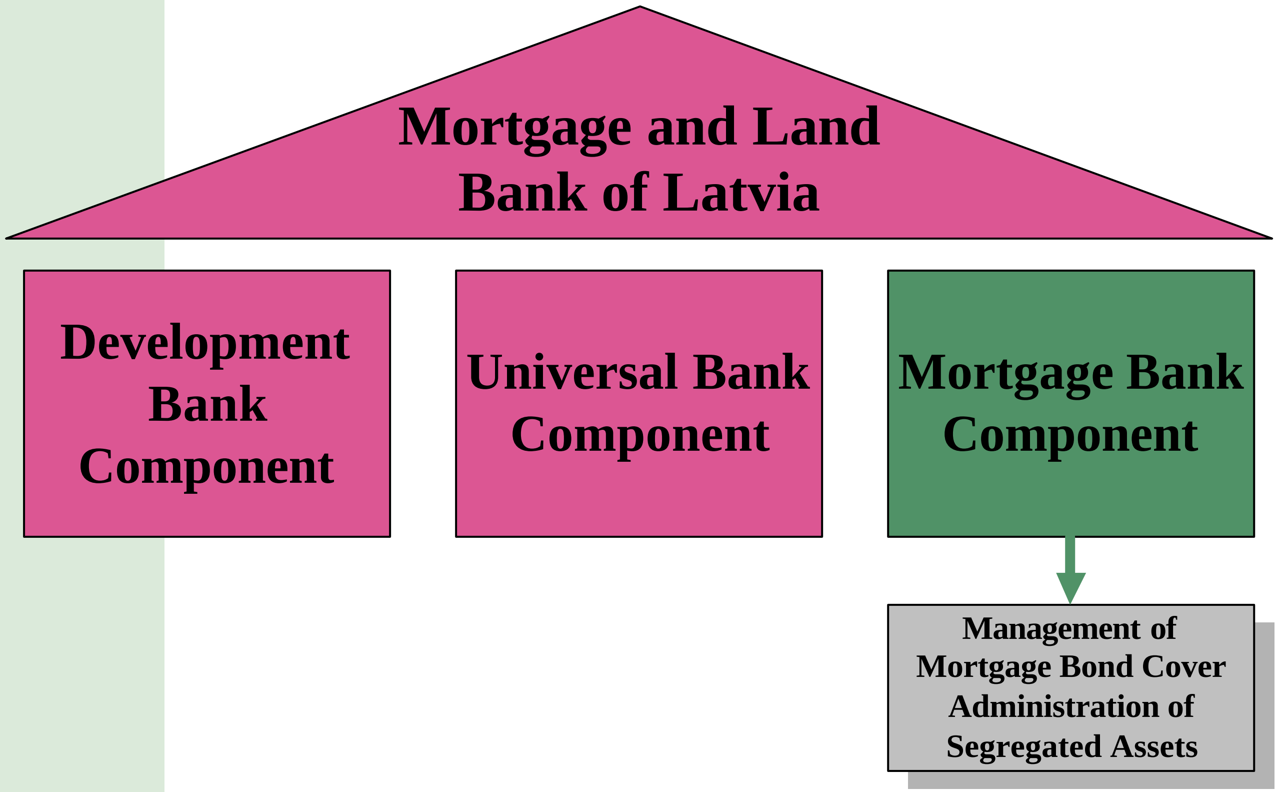


Principle of Pure Mortgage Bank



Principle of Mixed Mortgage Bank

Experience of Mixed Mortgage Bank Model in the Issuance of Mortgage Bonds



Mortgage Bond Cover – Pool of Segregated Assets

EUR/LVL=0.57

MB Redemption and Coupon Pmnts Date	Mortgage Loans		Mortgage Bonds in Circulation		Mismatching of Ordinary Cover	Substitute Cover	Mismatching of Mortgage Bond Cover
	Principal Payments	Interest Payments	Redemption Payments	Coupon Payments			
15.02.2002	258	493	1 000	277	-526	742	216
15.08.2002	477	459	0	234	702	0	702
15.02.2003	503	426	0	234	1 171	0	1 171
15.08.2003	530	391	1 600	234	66	91	157
15.02.2004	532	356	0	170	718	0	718
15.08.2004	571	320	0	170	1 254	0	1 254
15.02.2005	502	283	1 000	170	718	0	718
15.08.2005	422	253	0	128	1 152	0	1 152
15.02.2006	359	226	0	128	1 484	0	1 484
15.08.2006	349	203	0	128	1 810	0	1 810
15.02.2007	317	181	0	128	2 105	0	2 105
15.08.2007	345	159	2 400	128	28	4	32
15.02.2008	326	138	0	38	426	0	426
15.08.2008	316	117	0	38	720	0	720
15.02.2009	297	96	0	38	997	0	997
15.08.2009	624	67	0	38	1 591	0	1 591
15.02.2010	156	44	0	38	1 724	0	1 724
15.08.2010	160	34	0	38	1 874	3	1 878
15.02.2011	80	25	1 000	38	946	12	958
15.08.2011	438	20	0	38	1 378	18	1 396
Total	**7 559**	**4 291**	**7 000**	**2 426**			

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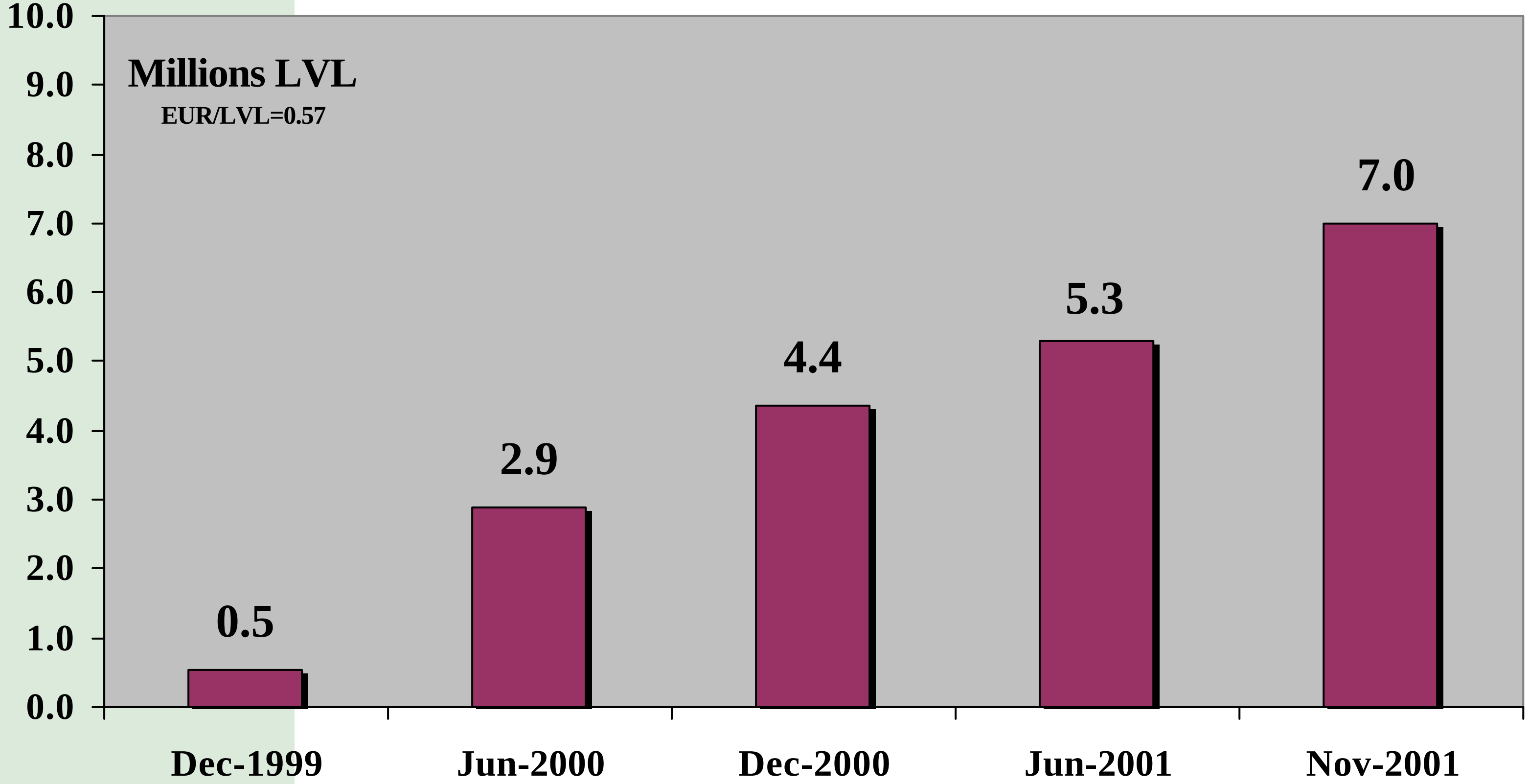
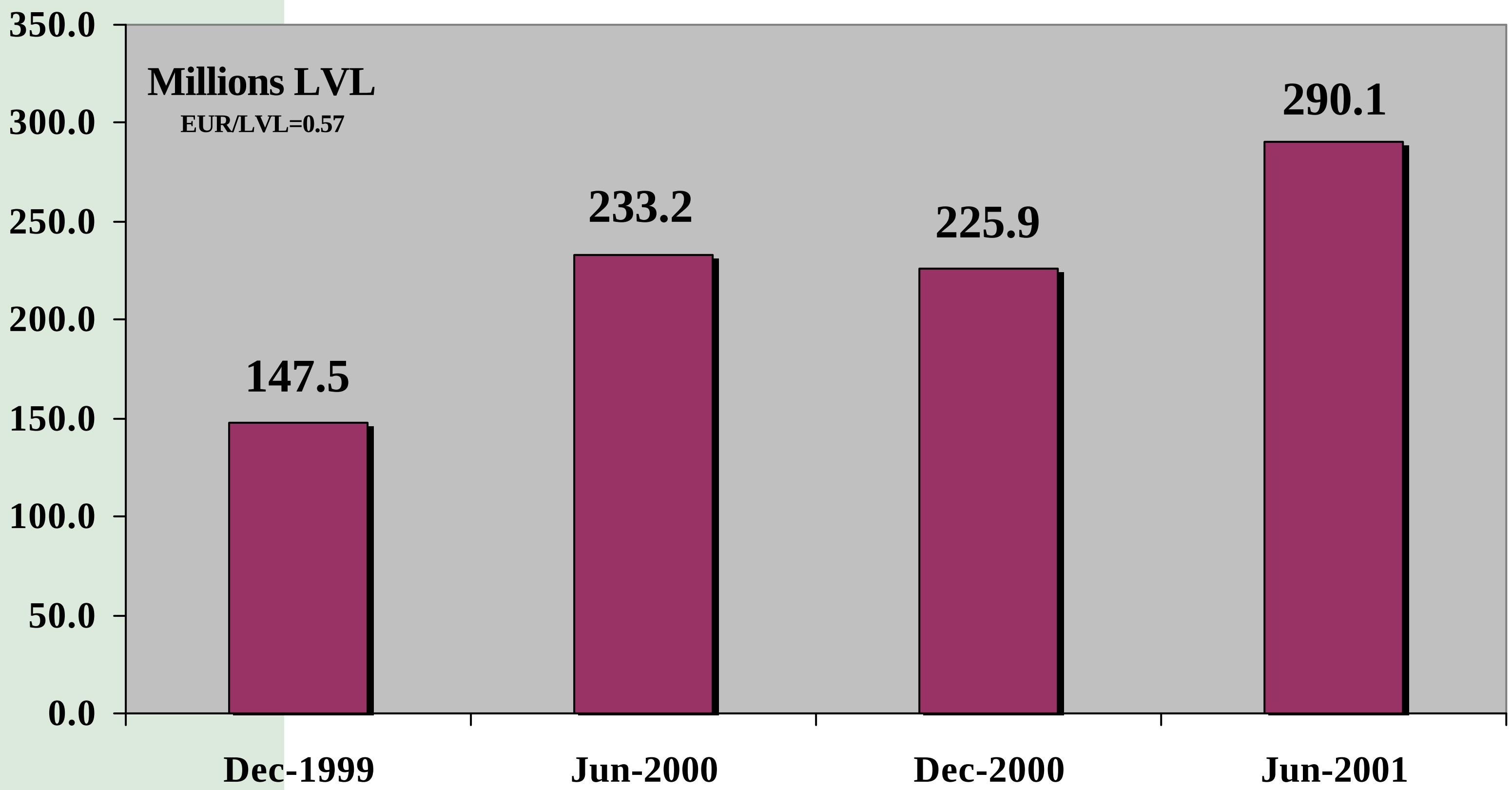
Volume of Mortgage Bonds Issued



Structure of Mortgage Bonds in Circulation

Name of Issuer	Series	Original Maturity	Volume in Circulation (LVL)	Coupon Rate	Yield to Maturity
Mortgage Bank	AC	3 Years	1.0 M	8.50%	6.55%
Mortgage Bank	AE	3 Years	1.6 M	8.00%	6.79%
Mortgage Bank	AF	5 Years	1.0 M	8.50%	7.39%
Mortgage Bank	AG	7 Years	2.4 M	7.50%	7.65%
Mortgage Bank	AH	10 Years	1.0 M	7.50%	7.70%
Total			7.0 M		

Volume of Government Debt Securities Issued



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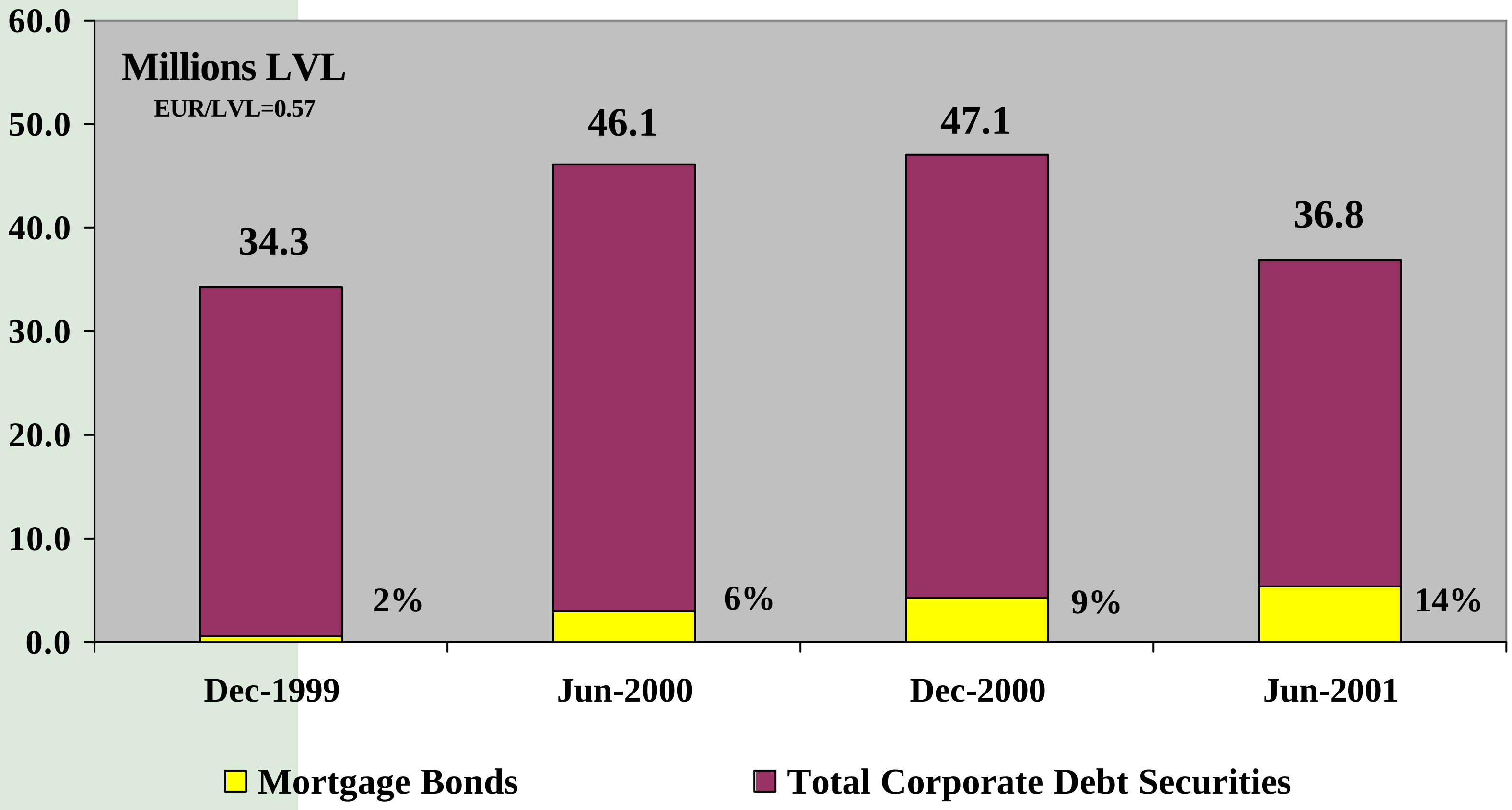
Volume of Corporate Debt Securities Issued



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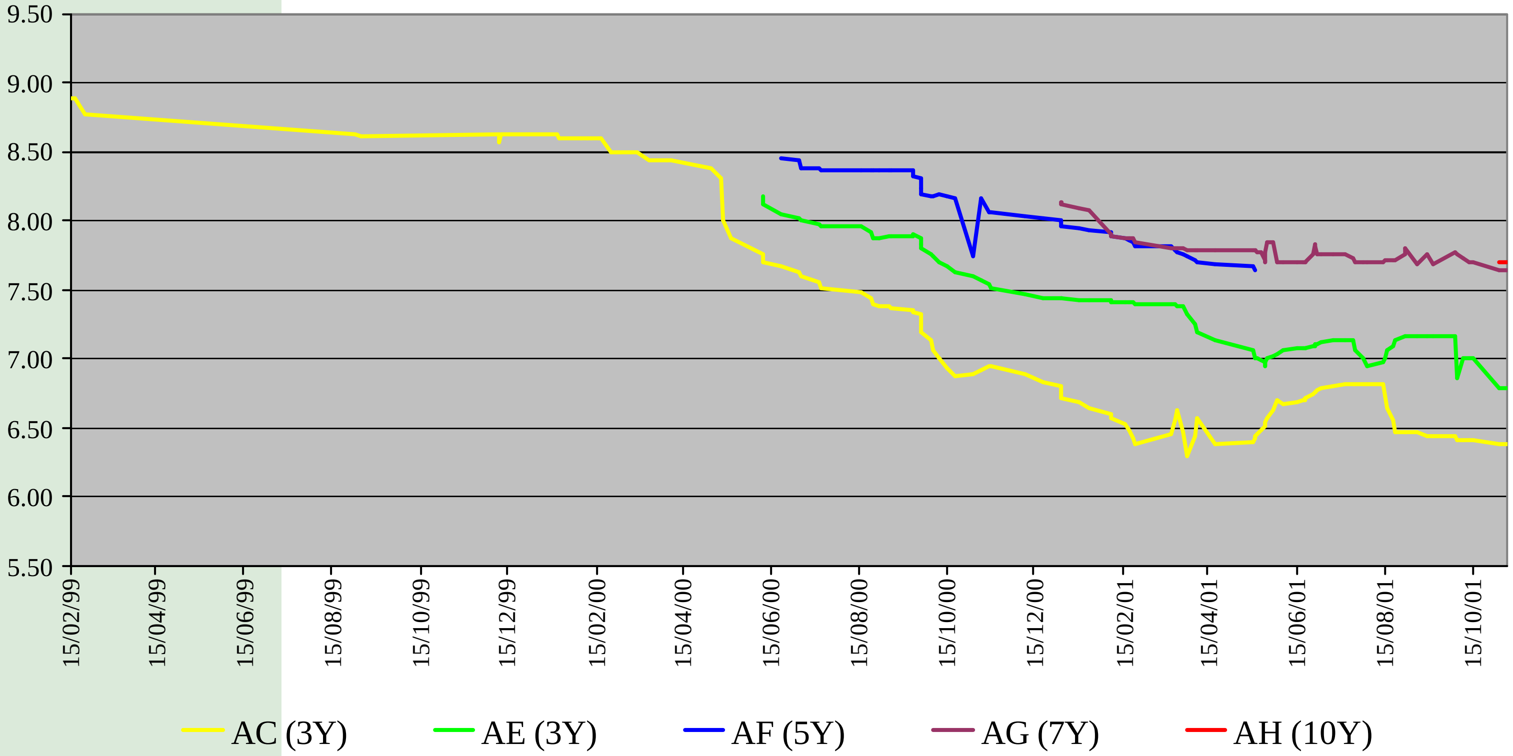
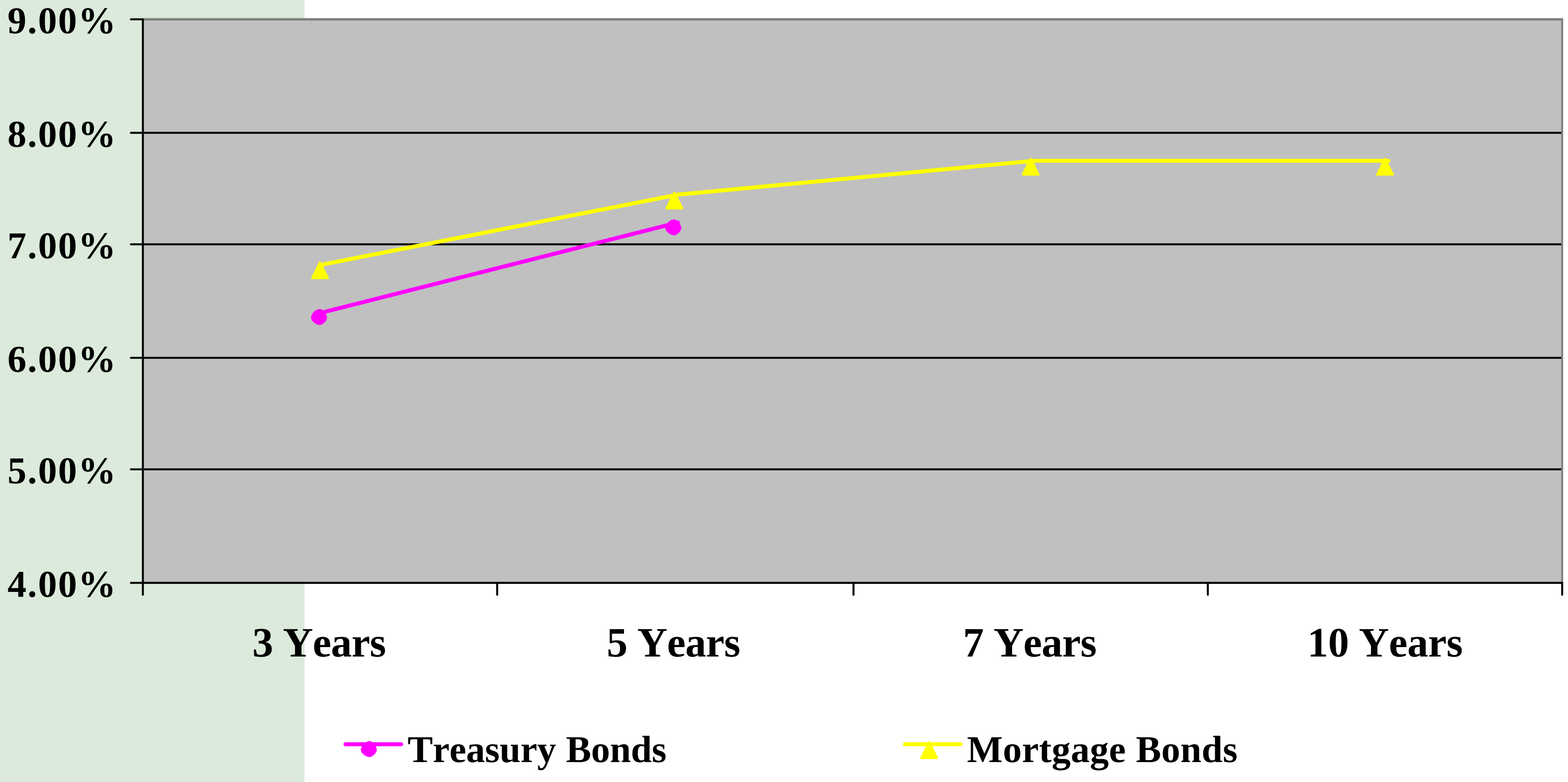
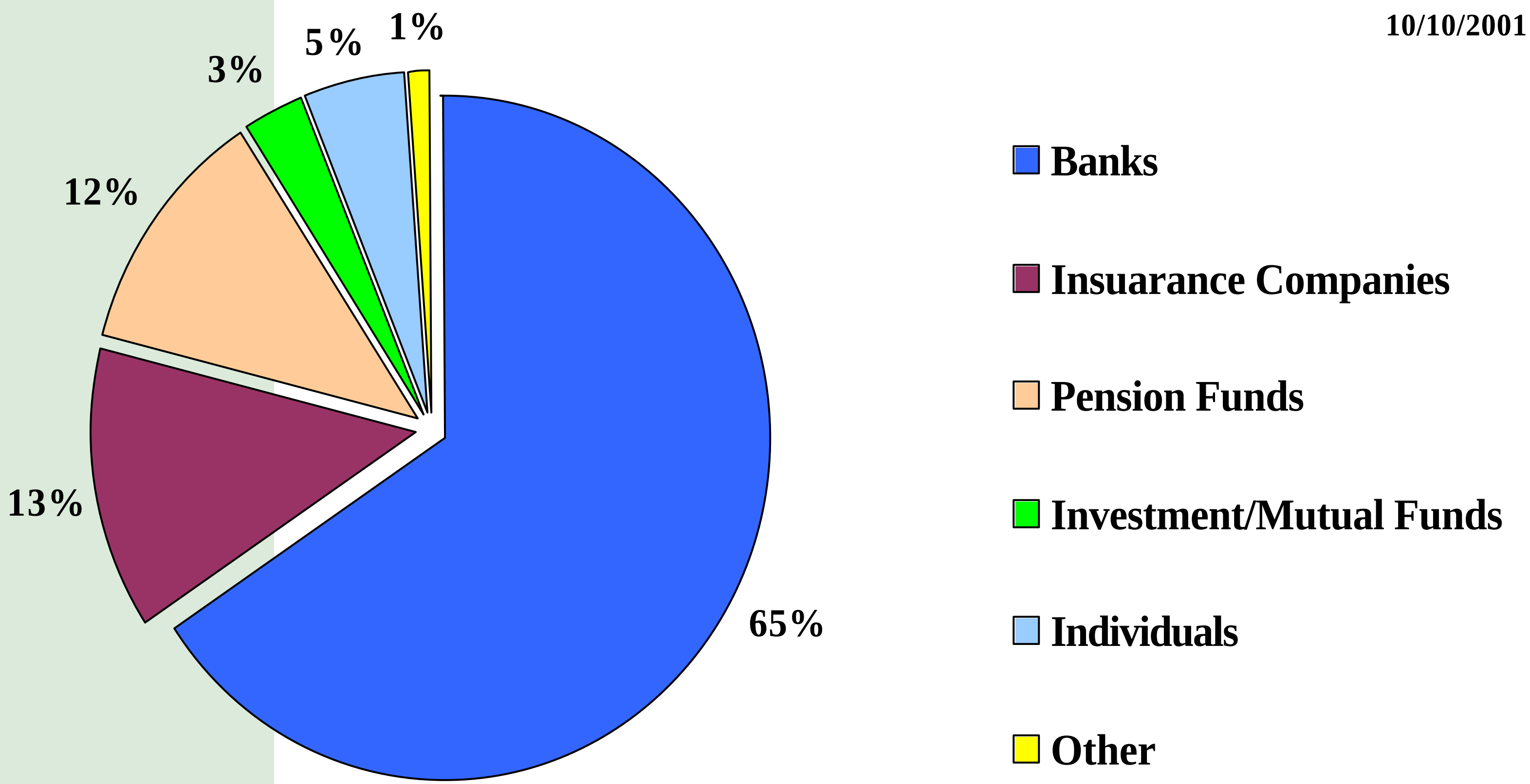
Mortgage Bonds Yield Curve on Secondary Market at the RSE



Comparision of the Treasury Bonds and Mortgage Bonds Yield Curves



Structure of Mortgage Bond Investors



Formation of Mortgage Bond Market in Latvia

by Rolands Paņko
Mortgage and Land Bank of Latvia

1. Already for several years Latvia has a complete legislative basis needed for the development of mortgage lending system.
The Mortgage Bonds Law which is the main law forming the system was adopted in 1998.
Besides there are other laws governing the system such as:
- Civil Law;
- Land Book Law;
- Civil Process Law;
- Credit Institutions Law;
- Securities Law.

To co-ordinate the improvement of the legislation the Working Group for the Development of Mortgage Lending System was established at the Ministry of Finance.

This year the following changes were made to the legislation governing the mortgage lending system:
1.1 On the basis of the experience gained during the first years of mortgage lending system in operation amendments were made to the **Mortgage Bonds Law**:

1.1.1 the maximum loan to collateral ratio was differentiated.

Now according to the amendments:
"A mortgage loan together with the debts previously entered in Land Book shall not exceed 75% of the pledged real estate which is used for permanent living throughout the year or 60% of the market value of other types of real estate".

1.2 This year the previously adopted amendments to the **Land Book Law** which stipulated the introduction of electronic land books in Latvia were brought into effect.
The system of computerised united Land Books has come into operation. The system offers by means of internet to see the topical informational about the real estates, look through the Land Book sections and obtain complete information about the records, contained therein, contents of property, owners and performed transactions quickly and remotely.

1.3 The amendments to the **Credit Institutions Law** related to the establishment of **Financial and Capital Market Commission** have taken effect this year on July 1. The Financial and Capital Market Commission incorporates the supervision functions of credit institutions, insurance companies and securities' market participants. Thus, the supervision of mortgage bond market is performed by one institution.

2. The Mortgage Bonds **Law** of Latvia **does not require** a specialised bank for issuing of mortgage bonds. Any bank complying with the requirements of the law may issue mortgage bonds. Doubtless, the most important requirement is to: "provide for segregated management of the assets included in the Mortgage Bonds' Cover Register from other assets of the bank". Since the very beginning the implementation of the segregated management or the principle of mixed type bank has been and still is a matter of ample discussions held at home and with foreign experts.

Opposite to many other spheres in the countries of transition economy, for example establishment of commercial banking system, where the experience of the developed countries of the Central Europe was transposed directly, the mortgage lending system, in our opinion, cannot adopt this experience to a full extent. The conclusion is based on the following considerations. As can be seen in Germany, Denmark and other countries the classical development of mortgage transactions leads to the establishment of highly specialised credit institutions – mortgage banks what has taken a very long time in the countries having a well developed mortgage lending system. The situation in transition economies demands thorough and most important instant economic reforms. At the initial formation stage of the market economy and in the circumstances of rapid economic changes as well as due to the uncertainty brought about by economic changes, the establishment and functioning of highly specialised mortgage banks is possible only with a wide support of the state. However, such a policy of the state would distort free competition and hinder the formation of real estate and capital markets based on the market economy.

As a result of these considerations and taking into account the limited financial resources of the state, Latvia chose the initial development path of the mortgage lending system what provided for such mixed banks which allowed issuing the mortgage bonds alongside performing the traditional transactions of the commercial banks.

A key condition for the implementation of such a development path is a complete protection of the interests of investors so that the investors in mortgage bonds are not subject to the risk which might occur due to the overall activities of the commercial bank. In a mixed type of bank it is possible to channel a certain amount of commercial profit to the development of the mortgage lending system as well as use the attracted term deposits to obtain mortgages of certain quality with the aim of refinancing these loans by issuing mortgage bonds.

The principle of mixed bank functioning in a small market allows of step-by-step implementation of the system and taking note of the practical experience at the each stage of development. Besides, this approach also allows of more efficient use of the capital basis of the mortgage lending institution at the initial development stage of the market when the volume of the specialised – mortgage transactions has not reached the volume necessary for capital adequacy as yet.

We are convinced that the chosen way - accelerated development path will also lead us to the establishment of specialised mortgage banks.

I would like to offer to your attention **an example of the implementation of mixed type bank** based on a case study of Mortgage and Land Bank of Latvia.

A separate structural unit, actually a bank within a bank, has been established for the issuing of mortgage bonds and management of Cover Register. As required by law the unit ensures segregated management of the assets entered into the Mortgage Bonds' Cover Register from other assets of the bank.

Cover Register is the main management and control instrument of the system of mortgage bonds.

Firstly, the Cover Register lists and makes legally valid the included assets which according to the law do not serve to meet the claims of other creditors, not even in a bankruptcy scenario of the bank;

Secondly, the Cover Register provides for the control of cover principle i.e. the face value of mortgage bonds outstanding must be covered with mortgage loans and substitute cover of the same amount, but the total interest expenses of the mortgage bonds must be covered with the total interest income on cover assets of the same amount;

And finally the Cover Register provides for the principle of congruence i.e. serves as the management instrument of the assets and liabilities to hedge the financial risks.

The new legislation governing the mortgage bonds has already been effective in Latvia for 3 years. During this time span the volume of mortgage bonds has increased from 0.5 to 7 million lats. The volume consists of the mortgage bonds issued by so far the only issuer in Latvia – Mortgage and Land Bank of Latvia. The Bank has issued mortgage bonds of five series with the maturities of 3, 5, 7 and 10 years. At the moment the mortgage bonds of 7 and 10 years maturity are the domestic currency debt securities with the longest maturity on the financial market of Latvia. It must be noted that the longest maturity of the domestic currency government securities is 5 years.

Characterising the debt securities market of Latvia in general the leading role of government securities whose total amount in the middle of the year was 290 million lats must be emphasised.

The total amount of other corporate bonds registered with the Central Depository of Latvia was 10 times smaller – 31.5 million lats as at end of June, 2001. The average share of mortgage bonds in the corporate debt securities' market is 10%.

Hence it follows that the expansion of the mortgage bond market is related to the overall development of the debt securities market.
So far the successful development of government securities market in Latvia by giving indications to the market has been a promoting factor also for the development of other debt securities.

Nevertheless, to overcome the complete dominance of the state on the bonds' market and provide for a more rapid development, appropriate measures must be taken to facilitate the registration of private issues and reduce the expenses related to the issuing of securities.

From the viewpoint of market formation public issues should be promoted particularly. Currently apart from the government securities only the bonds and mortgage bonds of the Nordic Investment Bank are issued publicly.

The mortgage bonds as public circulation securities have been defined in the Mortgage Bonds Law. All series of mortgage bonds are quoted in the Official List of Riga Stock Exchange and can be bought and sold freely in a continuous market.

The chart shows the yield fluctuations of the mortgage bonds upon the performed transactions. The yield of mortgage bonds is 0.5% above the rates of government securities of similar maturity. Lately, on November 5, for the first time the Moody's has assigned and made public the rating for the mortgage bonds issued by Mortgage Bank which is A3. The assigned rating is only one notch lower than the rating for the domestic currency government securities which is A2. Therefore we can expect the reduction of the rates' difference to approximately 0.25%.

4. The most important task to be accomplished at the formation stage of the mortgage bond market is the inclusion of mortgage bonds in the securities settlement system organized by Central Bank of Latvia to make the mortgage bonds an instrument in the monetary transactions of the Central Bank.

The amendments envisaging the expansion of the authority of the Central Bank have already been submitted to the Parliament. The proposed amendments will make it possible for the Central Bank of Latvia using also the mortgage bonds to engage in the practice adopted by Central Banks of Europe of using the securities in monetary operations.

The importance of this matter for the market of mortgage bonds is determined by the significant role the banks play on that market.

Firstly, looking at the structure of investors depicted on the slide we can see that banks are the largest holders of mortgage bonds. The possibility to use the mortgage bonds as refinancing instruments would significantly increase their liquidity and attractiveness for other banks.

Secondly, the banks are the main financial intermediaries – out of 14 financial intermediaries at Riga Stock Exchange 12 are banks. If the mortgage bonds are entered into the portfolio of the financial intermediary, they can be offered to other customers more knowledgeably and flexibly, thus promoting the distribution of mortgage bonds as a financial instrument.

Other most significant institutional investors are the traditional ones: insurance companies and private pension funds. Life insurance companies and pension funds have not accumulated remarkable financial resources as yet.

The main conclusions:

1. The model of mortgage lending system of Latvia has proved its viability. All the loans included in the Cover Register have been refinanced by issues of mortgage bonds.
2. The mortgage bonds have become the instruments of financial market recognised by institutional investors.
3. Further development of the mortgage bond market in Latvia is to be related to the general development of the corporate bond market and institutional investors.