CENTER OF LEGAL COMPETENCE

9th Central European Covered Bond Conference Budapest October 17 – 18, 2005

Verein zur Förderung der rechtlichen Ostkompetenz Österreichs

Wohllebengasse 6 A-1040 Wien Tel.: +43-1-503 73 35

Fax: +43-1-503 73 36 E-mail: office@clc.or.at

Panel discussions/questions
Legislative improvements in Central and Eastern Europe:
Quality of mortgage collateral

Executive Summary

I. Regarding economic significance of real estate liens

The great advantage of having a real estate lien as collateral security – be it in the form of an accessory mortgage or of a non-accessory land charge – lies, in particular, in its independence of the credit standing of the principal debtor and/or the party furnishing security, because the creditor has the position of a privileged creditor in the case of insolvency of the pledgor, i.e. in a situation where suitability of a collateral security is most clearly demonstrated.

Although also a credit which is secured by a real estate lien requires personal creditworthiness of the debtor, security lies in the object, i.e. in eligibility of the real estate as collateral. In addition there is the in rem effect of the lien, which remains even in case of a transfer of the object. Security rights in rem are obviously valued higher than personal security rights, like a suretyship or additional assumption of debt. Among security rights in rem, the real estate lien is the one that is most appreciated by lenders because, as a rule, the value of real estate, being non-increasable, principally non-consumable and, above all, durable property, remains stable and/or because increases or decreases in value are relatively easy to estimate. For this reason the real estate lien is, above all, suited as security for long-term financing. This special security results in the pleasant consequence for borrowers that a mortgage loan involves lower borrowing costs than a personal loan.

Especially against the backdrop of the Basle II Accord the significance of real estate liens becomes clear not only for the banking industry, but also for undertakings and private households, which depend on loans. The legislator of every state has the task of establishing the legal framework conditions which allow real estate liens to become an attractive and reliable collateral security in daily lending practice. If such framework conditions are not favourable, the disadvantages for economic growth and, generally, for economic welfare of every country are obvious: if a real estate lien is considered to be little reliable, quite a number of loans will not be granted – again against the backdrop of the Basle II Accord – or the borrowing costs will increase to such a degree that the entrepreneurial or private investment is abstained from.

In particular, it can be seen clearly from the statutory provisions covering three legal areas whether a real estate lien is a reliable and attractive collateral security:

Real estate lien and land register: The ownership situation regarding the pledged real estate must be clear or easy to clarify for the pledgee. Moreover, the pledgee's good faith in the lawfulness of the existing ownership structure must be protected to the greatest extent possible.

Real estate lien and seizure of real estate: A real estate lien must constitute collateral security that is "closely related to enforcement". This requires that, on the one hand, the legal framework conditions for real estate liens as such and the provisions of civil procedure law and enforcement law which are relevant to enforcement must be designed accordingly. On the other hand, the technical, institutional and staff-related framework conditions in the institutions in charge of enforcement must enable efficient execution of statutory provisions.

Real estate lien in insolvency: Suitability of a real estate lien shows best in the case of insolvency of the pledgor. A "reliable" real estate lien is characterised by the fact that at least almost the entire proceeds from the sale of the pledged property serve the purpose of satisfying the secured claims.

II. Real estate lien and land register

For good reasons the pledgee insists on the furnishing of proof that the real estate to be pledged is owned by the pledgor. Such proof may be furnished by establishing an uninterrupted chain of previous owners, for example by means of deeds, and such chain may, under certain circumstance, have to go back several hundred years. If such probatio diabolica can be achieved at all, it usually involves a lot of time and money, which in most cases puts the investment as such in question. If a bank grants a loan despite an existing risk of ineffective establishment of a real estate lien, such risk will be reflected in the terms and the price of the loan. Taking out an insurance against the risk of ineffective pledging may defuse the problem, however, an insurance constitutes a quite significant cost factor, which makes the loan more expensive in the end.

The legal situation becomes much more advantageous if a land register exists in the relevant country. In this context it should be borne in mind that the idea of a land register is not merely registration of real property and the rights in rem in such real property (although this task alone is quite helpful when it comes to finding out about the ownership situation), but especially that the land register has a substantive public disclosure effect. Through this effect the land register protects the reliance of those who make their dispositions on the basis of correctness of the land register. Accordingly, the information contained in the land register, as a rule, has priority over the actual legal situation, this being in the interest of real estate transactions. The positive side of the substantive public disclosure effect protects reliance on the correctness of the information of the land register, i.e. on the fact that entries in the land register are correct originally, i.e. from the beginning ("What has been registered applies."). The negative side protects reliance on the completeness of the data in the land register ("What has not been registered does not apply.").

It is obvious that the introduction of a land register which develops substantive public disclosure effect and, therefore, makes it possible for pledgees to acquire liens in good faith from a non-authorised party with legal effect makes the real estate lien a more reliable and, in addition, less expensive collateral security. Unfortunately, this is not or not sufficiently taken into consideration and not implemented in legislative terms or in the form of institutions in some countries of Eastern and Eastern Central Europe, in spite of a pronounced land register tradition.

Discussion will show the situation regarding registration of real estate in the countries of Eastern and Central Eastern Europe and the measures that may be taken to improve security and quality of real estate registration systems.

III. Real estate liens and real estate seizure

Reliability of collateral security is particularly reflected in the efficiency of realisation of the security in the event of the debtor's unwillingness to pay. The easier and quicker a security can be sold, the more a creditor will be ready to accept the lien as collateral security. From the creditor's point of view it would be most beneficial if the real property eo ipso became the property of the pledgee upon occurrence of the security event. For good reason such a forfeiture agreement is not permissible, and definitely not if it has already been agreed in the pledge agreement.

Therefore, court proceedings need to be initiated if the real property, being a pledged object, is intended to be realised. In this context the length of proceedings is of great significance, which is quite substantial in countries of Eastern and Central Eastern Europe. Discussion will show what measures can be taken to be able to realise real property being pledged objects more effectively.

IV. Real estate liens and insolvency

If insolvency proceedings are opened over the assets of a pledgor, in particular in case of insolvencies where the bankrupt's estate is poor, the only significant elements of the debtor's estate are real property – even if it has been pledged. Even if a jurisdiction privileges pledgees as preferred creditors, demands are raised by preferred creditors or unsecured creditors to enable satisfaction of preferential claims and insolvency claims also from portions of the proceeds from realisation of the preferential estate. Such demands are also reflected in the insolvency laws of some countries: there are, for example, regulations to the effect that only 70% or even only 50% of the proceeds from realisation of pledged real estate is to go to the preferred creditors. The rest goes to the general estate. Although such regulations may serve socio-political purposes, it must be considered nonetheless that the value of real estate liens as collateral security is reduced to an almost unbearable degree. If 50% of the proceeds from realisation of pledged objects go to the general estate, a preferential right is only worth half. The readiness and possibilities of banks to grant loans is reduced in this way.

Discussion will show whether in the near future legislative measures may be expected which are able to increase the value of real estate liens as collateral security also in case of insolvency.

Mario Thurner
Managing Director CLC