



Mortgages in transition economies

The legal framework for mortgages and mortgage securities



European Bank
for Reconstruction and Development

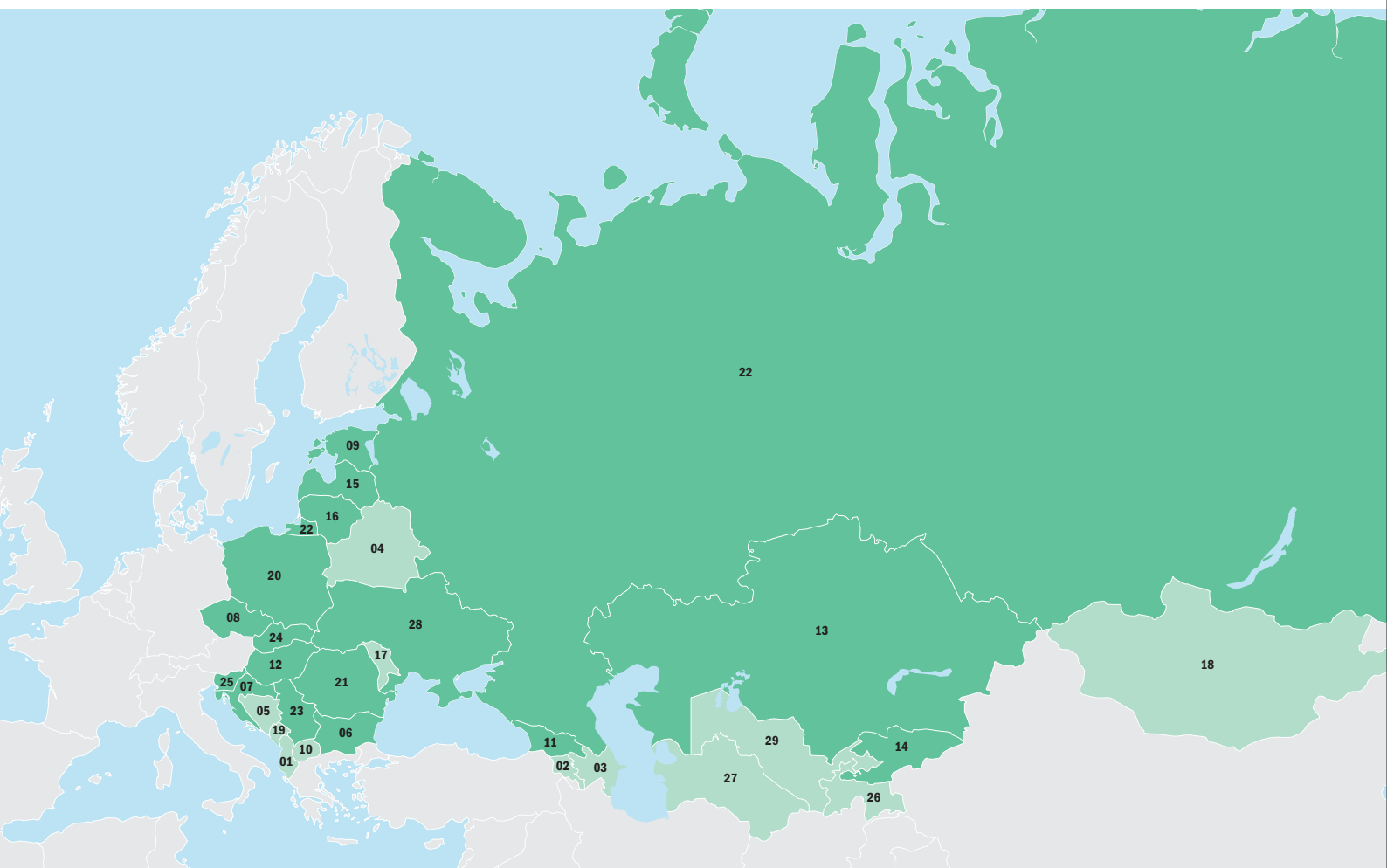
About this publication

The European Bank for Reconstruction and Development (EBRD) seeks to foster the transition from centrally planned to market economies in its 29 countries of operations. This includes encouraging countries to improve their legal environments by modernising their legal rules and institutions.

This publication aims to identify what legal reform is needed to achieve an efficient legal framework for mortgage. It was prepared by the EBRD's Office of the General Counsel with the generous support

of the Swiss State Secretariat for Economic Affairs (SECO). Although great care has been taken to provide accurate information, it does not constitute legal advice, and parties to mortgage transactions should seek their own advice.

In preparation for this publication, the EBRD conducted a survey of mortgage laws in 17 transition countries that have an active mortgage finance market or that are actively developing such a market. The survey can be extended to other countries.



EBRD countries of operations

01	Albania	09	Estonia	17	Moldova	25	Slovenia
02	Armenia	10	FYR Macedonia	18	Mongolia	26	Tajikistan
03	Azerbaijan	11	Georgia	19	Montenegro	27	Turkmenistan
04	Belarus	12	Hungary	20	Poland	28	Ukraine
05	Bosnia and Herzegovina	13	Kazakhstan	21	Romania	29	Uzbekistan
06	Bulgaria	14	Kyrgyz Republic	22	Russia		
07	Croatia	15	Latvia	23	Serbia		
08	Czech Republic	16	Lithuania	24	Slovak Republic		

Countries covered by the EBRD Mortgage Regional Survey are shown in dark green.

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Part I: Introduction

In central and eastern Europe and central Asia, access to private home ownership is a relatively recent phenomenon, principally as a result of the privatisation policies of governments moving from a communist to a capitalist system. It is widely seen as one of the keys to fostering economic prosperity, political stability and wider equality.¹ With the rate of private home ownership now exceeding 80 per cent in many transition countries,² it is evident that there is a huge capital stock that can be mobilised as collateral to secure loans for financing not only property acquisition but also improvements, business activities or personal consumption. In the business sector a significant proportion of the assets of many companies is in the form of real property and can be used as a means of facilitating access to finance.

Mortgage financing has always been a favourite form of financing for banks.³ The primary credit risk is supported by solid security that does not move and which normally maintains its value. The incentive to avoid default is high, especially with residential property because a borrower will make every effort to avoid losing his home. But mortgage markets are not only growing. They are changing fast with more and more new mortgage products. On the legal front the challenge facing transition countries is not just to ensure a suitable legal environment for established forms of mortgages but also to have in place the rules and institutions that are sufficiently adapted to the latest techniques of the market, and further will be able to adapt to the new techniques of tomorrow. And those techniques concern both the product that is offered to the customer and the way it is financed.

In the early 1990s in the immediate aftermath of the communist era in central and eastern Europe and central Asia, the legal problems surrounding real property ownership were numerous. The lack of reliable cadastral and title

registration combined with uncertainty over restitution rights limited the scope for using real property as security for credit. Although mortgage over real property was often the most favoured security for credit for all the classic reasons, the security was generally tainted by lack of certainty of title of the mortgagor (in other words, the person granting security) and the threat of competing claims to the mortgaged property. The development since then of land registration systems across many of the transition countries and the resolution of restitution claims has made mortgage a much more viable form of security and has opened up new possibilities for mortgage financing. The considerable efforts that have been made to stabilise and modernise the financial sector in the transition economies also expand the scope and nature of new products that can be developed.

Currently, mortgage activity is booming. In particular, the use of mortgage financing in residential housing markets is growing fast and is seen as having high potential for future growth. The techniques for financing the providers of mortgage loans have also changed with an increasing interest in using the mortgage loans themselves as collateral, whether for secured borrowing (with the mortgage lender issuing covered bonds (CBs)), by divesting the mortgage loan portfolio through securitisation (with the acquirer issuing mortgage-backed securities (MBS)). The European Bank for Reconstruction and Development (EBRD) published a list of minimum standards for mortgage loans in May 2004, which are adopted by all financial institutions receiving mortgage credit lines from the EBRD – and by many others who see these standards as a basis for a proper risk management strategy and for ensuring that their portfolios can be attractive to investors in the future.⁴ However, improvements in lending procedures and policies and a sound approach to mortgage lending cannot compensate for flaws in the legal and institutional systems.

Mortgage law reform is not necessarily high on the agenda for many transition countries.⁵ Taking security through mortgage is not a new concept – it has been used for a very long time, including in transition economies – and in most countries the market for mortgage finance is developing anyway, so debate around mortgage law concepts, or indeed any call for reform, tends to be dismissed. There has been a good deal of reform activity concerning land law, title to real property and registration, and now laws are being introduced to encourage the use of CBs and MBS (referred to together as “mortgage securities”), but the legal provisions specifically covering mortgage as security have been largely overlooked. And yet mortgage rules have not always developed in the most rational and legally efficient way.

At the start of the transition process, most of the transition countries provided for the possibility of taking security over immovable property, usually on the basis of laws that had their origins in the pre-communist era. The reform priority at that time was to enable *movable* property to be used as collateral. Not only was there an absence of rules governing security over movables, but also many borrowers did not have suitable real property to offer as security. In the 1990s the EBRD and other sponsors of law reform in central and eastern Europe and central Asia concentrated on encouraging the introduction of viable secured transactions laws for movables.⁶ However, although for pragmatic reasons the initial emphasis was very much on pledges over movables, the EBRD approach has always been to treat mortgages as an integral part of secured transactions and to apply the same legal principles (while recognising that, in some respects, the mechanics may be different).

The purpose of this work is to look at mortgage law as it is currently used in transition countries against the background of contemporary markets for mortgage finance as they are developing globally. In particular we seek to:

- focus on the economic objectives that the law is to serve – the concept of “legal efficiency”, which is so often lost in the legal reform process. For mortgages it is especially important to distinguish the features of the regime that are serving an essential economic function from those that exist for historical reasons or to circumvent restrictive or inefficient elements elsewhere in the legal system. Any reform should be driven by the needs of the market, not by legal theory or legal history
- apply to the field of mortgage the lessons learnt by the EBRD through its extensive exposure to pledge law reform. The context for pledge law reform has been different yet, economically speaking, pledge and mortgage fulfil the same purpose and it is illogical that the reform of the legal framework for each should be conducted in isolation
- provide a dispassionate analysis of existing systems in transition countries. The EBRD has always aimed to put forward ideas that are compatible with the civil law concepts that underlie many central and eastern European legal systems and, at the same time, to draw on common law systems that have developed many ways of accommodating modern financing techniques. The objective is to emphasise the results to be achieved, while respecting that there may be many routes to achieve them, and highlight the opportunity that reform can give transition economies to “leap frog” older markets.

A vast amount of material has been produced in recent years concerning mortgage markets in transition countries and globally. The European Commission is expected to publish

before the end of 2007 a White Paper on Mortgage Credit in the European Union, following the publication in July 2005 of a Green Paper.⁷ The Green Paper looked at ways in which greater integration could result in a more efficient and competitive mortgage credit market in the European Union. From a legal perspective there is now extensive material available that describes the structures used for *mortgage finance* transactions, especially *mortgage securities* (see the selected bibliography in Annex 5). However, for the transition country that wants to modernise its legal framework for *mortgage* there is a lack of comprehensive and objective guidance on the basic issues involved. It is that gap that this work aims to fill.

This work focuses on mortgage, the security that is given by contract over real property, which is a core ingredient in any mortgage finance transaction.⁸ Research indicates that the quality of the law in itself influences lenders’ appetite for mortgage lending. The Banking Environment and Performance Survey (BEPS), which was conducted by the EBRD and the World Bank in 2005, has shown that when lenders perceive the legal framework for mortgages as being comprehensive, predictable and efficient, they are more likely to extend mortgage credit.⁹

It is not possible to comment on mortgage law without referring to many other areas of law, such as land law, but we try to do so only to the extent necessary to explain the issues that are addressed in this work. And although we look particularly at residential mortgage markets, we do not underestimate the importance of commercial mortgages, which present very similar legal issues.

The legal framework for mortgage is, however, looked at comprehensively. It is not just the law on the books, but it also includes the way the law is applied, the institutions that apply it and, ultimately, the result that is delivered. The starting point for our analysis is to look at what is needed to provide an efficient security instrument

in the context of modern market practice (and predictions of future trends). Only then should the precedent of laws of countries with more advanced mortgage markets be examined. Most mortgage laws were designed a long time ago. Even where they have been adopted recently they are based on much older laws, but the mortgage markets of 2007 bear little relation to those of 50 or 100 years ago.

Following this introduction this publication is divided into five parts. Part II gives a brief background on the economic context and introduces the criteria that are used in assessing mortgage laws. It develops the concept of “legal efficiency” on which many of the recommendations and conclusions are based. Part III analyses mortgage law, separating the issues between creation and enforcement. For both parts we give an overview of the legal steps involved and then examine specific legal issues that are particularly significant in practice to mortgage finance transactions.

As part of the research leading up to this work the EBRD conducted a survey of mortgage laws in 17 transition countries (the “Mortgage Regional Survey”) and the findings of that survey are presented in Part IV and set out in Annex 2. The methodology used was similar to that of the EBRD Regional Survey of secured transactions, which covers security over movable property and was first published in 2000. Part IV contains a commentary on the survey and a comparative overview which helps to show the progress that has been made in developing efficient systems for mortgage and the weaknesses that still exist. Although not formally included in the survey we have also had regard to the legal regime that applies in western economies with active mortgage credit markets, in particular England, France, Germany, the Netherlands and the United States. It is not the role of this exercise to assess the legal efficiency of the mortgage system in those jurisdictions. However, from the viewpoint of a

transition country, it is interesting – and sometimes revealing – to look at western systems against basic criteria. This can help to determine those elements that can be used as an example or even a template, and those that are less suitable.

Part V examines the legal framework for mortgage securities, concentrating on legal issues relating to mortgage law that affect the efficiency or even viability of mortgage securities. After a brief look at the background to mortgage securities and an overview of the legal basics for CBs and MBS, there follows an examination of certain legal issues that are of particular relevance when structuring transactions involving CBs and/or MBS. Finally, Part VI sets out some conclusions and recommendations.

As in previous publications on secured transactions of the EBRD, this publication is aimed at a diverse audience, and seeks to draw attention to, and increase the understanding of, issues that may have been passed over until now, or where a “lawyerly”

approach may have concealed more market-oriented solutions that could bring greater efficiency. There is an emphasis on the constant need for transition countries to analyse and understand the legal framework for mortgage, to correct any obvious deficiencies and to regularly fine-tune the way the legal system operates in order to ensure that it responds to the needs of the market. The cost and effort involved in doing that should be relatively low, whereas the potential economic benefit in the medium term to the country that follows that approach is doubtless relatively high.

It is hoped that the Mortgage Regional Survey that is published as part of this work will provide a useful basis for assessment and comparison and will become a reference point that provokes discussion and improvements to mortgage laws, especially among those who make or influence legal reform policy in the region, enabling them to improve their mortgage laws in order to achieve “legal efficiency”.

Endnotes

- 1 See for example International Monetary Fund (2006), *Global Financial Stability Report*, Chapter II on Household Credit Growth in Emerging Market Countries, p. 69: “The healthy development of household credit is likely to generate important benefits for borrowers, lenders, the financial system, and the economy. It can also alleviate some of the current global imbalances. The resulting welfare gains could be substantial. Therefore, there is a need to encourage the sound development of this still-nascent market in Emerging Markets and developing countries.”
- 2 See European Mortgage Federation (2006) *Hypostat 2005, A Review of Europe’s Mortgage and Housing Market*, which indicates that this is the case in Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, Romania, Serbia and Slovenia.
- 3 Mortgage is an ancillary right in immovable property entitling a creditor to recover his claim out of the mortgaged property. In legal terms it is important to make the distinction between the mortgage and the loan that it secures (see the terminology in Annex 4).
- 4 See the EBRD strategy for mortgage finance at www.ebrd.com/country/sector/fi/debt/products.htm and the List of Minimum Standards of Mortgage Loans and Mortgage Manual, (July 2007) at www.ebrd.com/country/sector/fi/debt/mortstan.pdf.
- 5 The term “mortgage law” is used to refer to the law governing mortgages as security and does not extend to the laws governing loans that may be secured by mortgages (see the terminology in Annex 4).
- 6 The EBRD published a Model Law on Secured Transactions and Core Principles for a Secured Transactions Law. Almost all transition countries introduced new legal provisions on pledge during the 1990s. See www.ebrd.com/st for further information.
- 7 See European Commission (2005) *Green Paper Mortgage Credit in the EU*.
- 8 This work does not deal with rights given by law to the providers of funds for the purchase of property.
- 9 See *Transition Report 2006: Finance in transition*, EBRD, Executive summary, and p. 63 ff.

Part II: Legal efficiency

1 The economic and historic context

The current volume of residential mortgage lending in advanced economies such as in the United Kingdom or Spain is impressive and there is every indication that there remains scope for further growth. In the transition countries, current volumes are lower but the rate of growth is faster and the potential for future growth correspondingly greater. Chart 1 shows the ratio of residential mortgage debt to GDP in 2005 in 14 transition countries, the average being 7.5 per cent, against the average in the EU-15 countries of 50 per cent. Chart 2 on page 8 shows the growth of residential mortgage debt between 2002 and 2005. The contrast is particularly striking for 2004-05, when the average growth for the 14 transition countries was 56 per cent against an average growth for the EU-15 countries of 9 per cent. Figures on commercial (non-residential) mortgages are not available but indications are that the sector is growing too.

Naturally, transition countries are keen to understand the factors that determine market growth for mortgage credit in advanced economies, and consequently what may be needed to encourage and maintain growth in their own markets. In this respect the way mortgage loans are funded is critical and has recently been changing fundamentally.

In many countries mortgage credit has mostly been funded in ways that create no legal links between the mortgage loans and the source of funding. The lender obtained funding from traditional sources, such as customer deposits, inter-bank borrowing or bond issues, and the fund provider had no direct right or interest in the mortgage loans for which the funds were used. However, two models have been used which facilitate funding by creating such a link.

In the US model, banks originated mortgage loans but they were not kept on the banks' balance sheets; instead they were packaged and sold to specialist government sponsored entities (such as Fannie Mae, Freddie

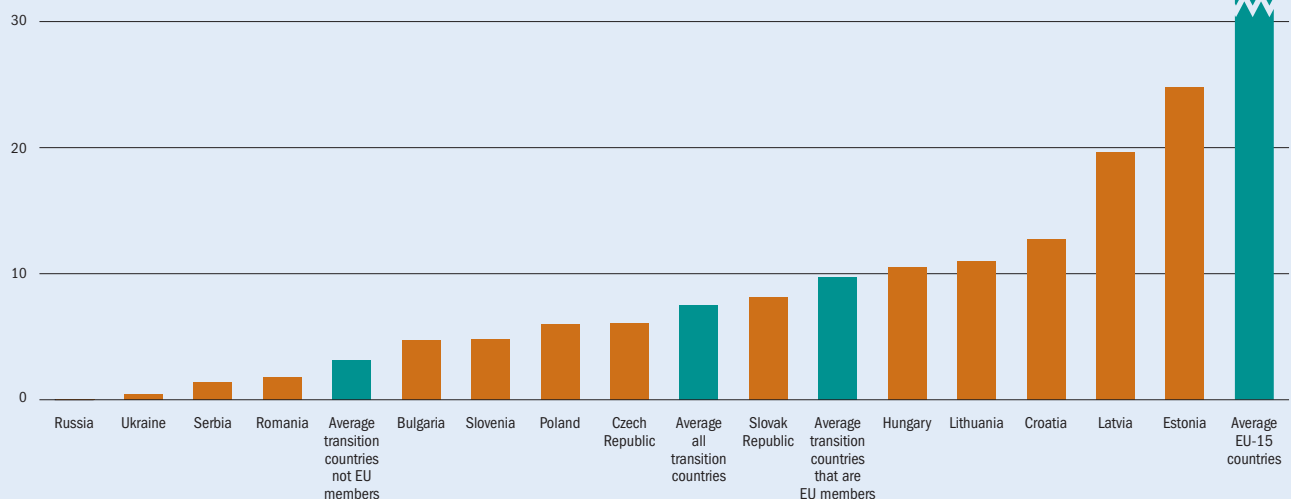
Mac and Ginnie Mae). These entities in turn financed their portfolios through the issue of securities, which were given a high credit rating not only because of the underlying mortgage loan portfolio but also based on either an implicit or an explicit government guarantee. By contrast, under the German model of *Pfandbriefe*, mortgage loans were retained on the balance sheet of the lending bank but used as security for bonds issued by the bank to finance its property lending business.

Behind the many permutations that may be offered to borrowers, the basic mortgage product tends to remain, in legal terms, essentially the same, involving a contract for credit secured by mortgage over real property. Yet the specific features of domestic mortgage markets have influenced the shape of the mortgage product. Historically, it has tended to be very country-specific. However, the global trend towards more open and more competitive markets both for customer lending and for bank borrowing has led to huge change. Frontiers have blurred and an increasingly

Chart 1

Volume of residential mortgage debt to GDP in 2005

Mortgage debt to GDP, in per cent



Source: European Mortgage Foundation

Note: The volume for Russia is 0.01 per cent. Figures on other transition countries are not available. Averages are highlighted for ease of reference.

broad array of different mortgage products is offered to potential borrowers. There is a move away from the inflexible standard mortgage – the one-product-fits-all approach – towards the adaptable product that can be tailored to the needs of the market and of the transaction. For transition countries, this represents both a challenge and an opportunity.

Rather than attempting to analyse the ever-growing range of variations and enhancements that may be made to a standard mortgage, this work looks at how the legal framework for the basic mortgage product can give the widest scope for product flexibility in fast-changing markets. Similarly, rather than attempting to analyse all the different possible types of mortgage securities, this work focuses on two broad types: covered bonds and mortgage-backed securities (see Part V), and looks at how the basic legal framework for

using mortgage loans for issues of covered bonds and mortgage-backed securities can give the widest scope for product flexibility.

In transition countries every opportunity for enabling and accelerating the transition process needs to be used to the full. One of the ways to do this is through adapting the legal framework to support the legitimate and justified needs of the market. Laws and the way they are implemented have to be “efficient”. While ensuring that the legal framework is capable of meeting market needs, each jurisdiction has to strike a balance between protecting debtors and encouraging creditors. Debtors need some degree of protection, but over-protection inevitably leads to a reduction in availability of credit. This publication does not attempt to address where the balance should be struck. We start from the position that greater availability of credit will lead to economic

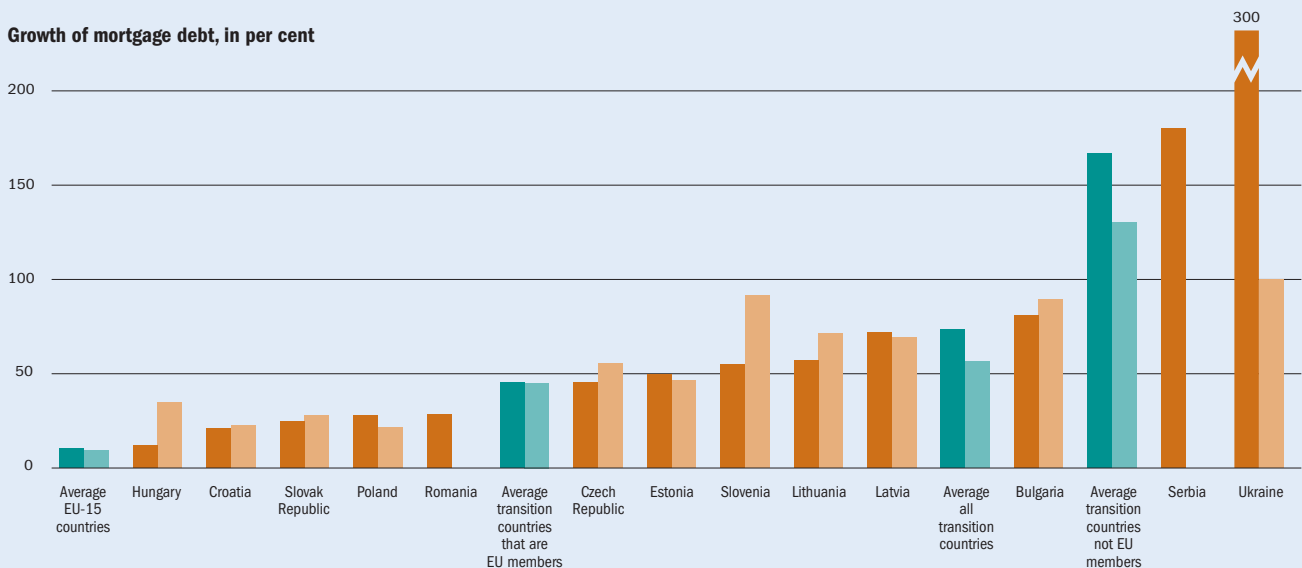
benefits. We recognise the importance of providing adequate debtor protection and we analyse the effect of different debtor protection measures so that, when deciding the appropriate solution for its citizens, a country may be aware of the probable impact on credit availability.

The process of modernising laws through reform can be fraught with problems; the pragmatic solution often is to adopt ad hoc laws that are limited in scope, or for lawyers to devise structures within the existing legal rules. However, in the transition countries there is the option of carrying out a dispassionate review of the legal framework against economic and market prerequisites in order to propose comprehensive reforms that aim to maximise the economic advantage that can be derived from the use of mortgage credit and mortgage securities.

Chart 2

Growth of mortgage debt between 2002 and 2005

Growth of mortgage debt, in per cent



Source: European Mortgage Foundation

Note: Data for Russia not available. Averages are highlighted for ease of reference.

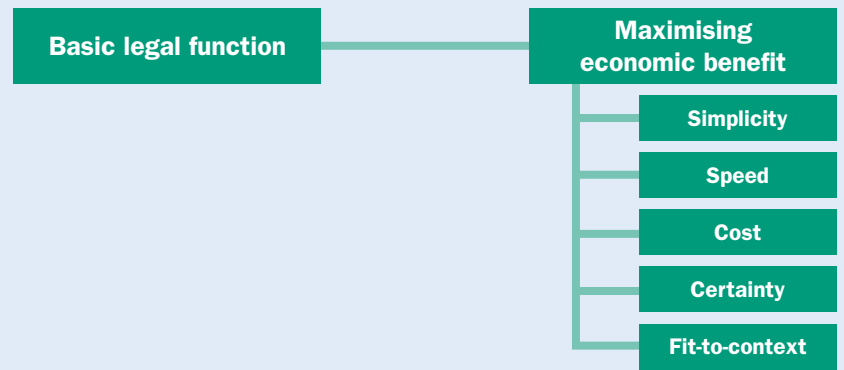
■ Annual growth in 2004-05
■ Average annual growth between 2002 and 2005

2 Legal efficiency criteria

What is meant by “legal efficiency”? Two important features of a law regulating mortgages need to be emphasised. First, its prime purpose is economic, since the mortgage market has essentially an economic function (while recognising that the housing market that mortgages finance has an important social function). Secondly, it is essentially facilitative since a mortgage market is not a necessity, it being possible for any jurisdiction to function without it. The premise is that the basic legal framework should be conducive to a flexible market for mortgage credit and for the issuance of mortgage securities, although there may be local political considerations that determine how far a country wants to allow its mortgage market to develop and what restraints or conditions it wants to impose on its operation.

A relatively simple indicator of the success of a mortgage law reform would be the subsequent increase in the volume of mortgage lending, but that is a crude and narrow indicator, inadequate by itself. The intended function of the mortgage market may be more than just to boost the amount of credit granted against security of mortgage. It may also include, for example, opening up credit to new sectors of society, or encouraging new housing construction. Also, if a mortgage law is reformed without thought being given as to what is necessary to facilitate the issuance of mortgage securities, be they CBs or MBS, the growth of mortgage lending may be limited because of legal issues affecting the funding. A law’s intended function has to be looked at in the context in which it is to operate. Its ramifications must be considered, not just in economic terms but also in social and cultural terms. An appropriate balance needs to be struck between fulfilling the law’s economic purpose and ensuring that the effects of the law are acceptable in context. The purpose of the reform needs to be carefully analysed and agreed at the outset,

Chart 3
Criteria for legal efficiency of mortgage law



failing which the potential achievements of the law in terms of legal efficiency may be curtailed.

Legal efficiency is therefore analysed by looking at the degree to which the legal framework enables mortgages to (i) achieve their basic function and (ii) operate in a way that maximises economic benefit.

As shown in Chart 3, the second criterion is split into five categories: simplicity, cost, speed, certainty and “fit-to-context”.

The basic legal function of a mortgage law is to allow the creation of a proprietary security right over real property in favour of a creditor which, in the case of non-payment of a debt, entitles him to have the property realised and the proceeds applied towards satisfying his claim before those of other creditors. If a mortgage law only gives the creditor a personal right but no right in the property, or if there is no right to enforcement or no priority over other creditors, the law fails to achieve its basic legal function.

An absolute priority for taxes and other state claims ahead of the mortgage creditor, or the right in insolvency of unsecured creditors to share a portion of the proceeds of mortgaged property, are more than inefficiencies in the mortgage law – they are defects that prevent it from fully achieving its basic function. They may be intentional (a super-priority of the state usually is)

but they reflect a compromise between two laws with conflicting purposes. Any such compromise inevitably inhibits the effective operation of the mortgage law and introduces uncertainty into the minds of lenders.

If the legal framework for mortgage is to operate in a way that **maximises economic benefit**, the system for creating and enforcing the mortgages should be simple, fast and inexpensive, there should be certainty as to what the law is and how it is applied, and it should function in a manner that fits the local context.

Simplicity – Simple does not mean simplistic: it is necessary to strike a balance between simplicity and the sophistication required by the market. In many countries complexities have developed and become entrenched over time as laws have been adapted to new circumstances, not because of the sophistication of these circumstances but rather from inherent limitations of the legal system. There exists in transition countries a huge opportunity to reduce down to the essential elements and to introduce laws that are directly adapted to modern market requirements. Simplicity partly comes from the lack of restrictions and barriers. If the law is to encourage the use of mortgage and mortgage securities it needs to provide a base that offers the necessary flexibility to adapt to the trends of the market.

Speed – For most aspects of the legal process, the less time it takes the more efficient it is. There are exceptions: a notice period or a cooling-off period should be of appropriate length, but for registration of mortgage, for example, there can only be benefits if it takes only a few minutes rather a month, and a lender who knows that the mortgage is likely to take several years to enforce will derive less comfort from his security.

Cost – Legal costs almost inevitably have an adverse impact on the economic benefit of a transaction. Delay, complexity and uncertainty all tend to add to costs so there is a close relationship with the other aspects of legal efficiency. Some costs are within the control of the parties. Before taking legal advice on structuring a transaction the parties can assess the value of doing so. The cost of legal advice on a complicated transaction may be outweighed by the benefits. However, the cost of legal advice incurred because of defects in the legal framework always reduces efficiency, as do fixed costs (for example registration, notary or court fees).

Certainty – Certainty is a critical element of any sound legal system. A grain of uncertainty in the legal position can have a pervasive and disproportionate effect. Once a banker hears that there is some doubt in the legal robustness of a transaction, he will fast become hesitant. The difficulty is one of measurement. If the legal uncertainty relating to a mortgage could be stated, for example, as a 5 per cent chance of proceeds on enforcement being reduced, with the amount of the reduction being on average 20 per cent, the risk would be quantified and it would become easier to manage as there would be relative certainty. But in reality legal opinions cannot be expressed in that way and the natural reaction to unquantifiable uncertainty is extreme caution. Transparency can often strengthen certainty: for instance, easy access for all to information in the land register allows potential mortgage lenders to find out about the property and any other mortgages that may be claimed.

Fit-to-context – This criterion is the most elusive but nonetheless important since it covers a number of facets. It is not enough to adopt a law that establishes clearly and unambiguously a simple, fast and inexpensive regime for mortgage security. The efficient functioning of the law will also depend on whether it is adapted to the economic, social and legal context within which it is to operate. It needs, for example:

- to respond to the economic need. Markets are constantly changing, and the law has to be able to adapt to new products, as for example when loans are proposed with flexible interest rates
- to fit the broader financial context within which the law operates. For example, when the legal nature of mortgage loans makes them unsuitable for securing bonds or for securitisation, the potential for the mortgage lender to extend his funding options and use instruments developed in other markets becomes limited
- to correspond with existing market practice. Whereas much can be learnt from other markets, a law has to be compatible with existing market and legal practice and to give confidence to those who rely on it
- to achieve an appropriate balance between fulfilling the economic purpose and ensuring that the effects of the reform are acceptable in context. The rights of consumers and occupiers of property to appropriate protection cannot be eliminated to suit the economic needs of the mortgage law. Rather, they have to be framed in a way that enables borrowers and lenders to derive the benefits afforded by a flourishing mortgage market while ensuring the necessary protections to persons in a vulnerable position
- to achieve particular objectives of the law. For example, the law may aim to extend mortgage lending to a wide range of banks as opposed to creating a lending cartel or to reduce constraints on the types of mortgage product that can be offered.

A basic assessment of whether a law maximises economic benefit may appear relatively simple. If the law enables a mortgage to be taken and, if necessary, enforced simply, quickly and cheaply, the cost of security by way of mortgage is minimised and the benefit of the security is maximised.

However, there are broader aspects that need to be taken into account. Legal inefficiency may not merely reduce the economic benefit that might otherwise result from the law (for example a lower interest rate for mortgage loans compared with that of unsecured loans), it may also have a dissuasive effect. This is particularly pertinent where the economic impact is difficult to measure. If the legal process is complex or takes a long time, or if there is uncertainty, potential players may never pass the decision threshold, and not proceed with the transaction at all. And if a few people take that line the impact may be multiplied as their conduct influences others.

Measuring legal efficiency is clearly challenging and any attempt to develop an accurate scientific basis is unlikely to be convincing. However, a close examination of a legal system against the legal efficiency criteria listed above can provide indicators of how efficient the system is. We have used the information from the Mortgage Regional Survey to produce some such indicators and they give an interesting insight into the strengths and weaknesses of these existing legal regimes (see Part IV). In commenting the survey and the indicators some reference is made to western European legal regimes in order to provide a reference point for transition economies and to emphasise, on certain aspects, the opportunity for transition economies to leap-frog over them.

The analyses in the following parts of this work, the recommendations made and conclusions drawn are influenced by the overriding economic rationale that should drive any mortgage reform and the need to achieve legal efficiency.

Part III: Mortgage Law

1 Legal basics - core principles

For a transition country that is seeking to modernise its legal and institutional system for mortgage in order to encourage growth in mortgage finance, the obvious starting point is to look at how the law works in advanced western economies. That exercise reveals a variety of different systems, mostly shaped in a different era, which have been more or less adapted over the years to accommodate market changes. Some aspects are highly efficient and show how long-standing laws and practices can be moulded to follow the needs of subsequent generations. Others are restrictive and preclude techniques commonly used in modern financing.

However, this approach ignores the fact that a transition country's stance is often different to an advanced one. It starts with a deficient legal framework and limited market practice, and wants to move in a short space of time to being able to compete with developed economies. One of the opportunities that the transition country may have is precisely the ability to avoid the kind of obsolete elements in the law that often hinder development in advanced economies.

For a number of years the EBRD Core Principles for Secured Transactions Law have been widely used in transition countries as a starting point for reforming security laws. They are very basic and simple but they contain the essential requirements that the legal framework has to meet, leaving it to each country to decide how best to achieve them in the context of its own jurisdiction. They apply to mortgage as much as to any other proprietary security. The principles are set out in Box 1 and in more detail in Annex 1.

Box 1

EBRD Core Principles for a Mortgage Law

- 1 A mortgage should reduce the risk of giving credit, leading to an increased availability of credit on improved terms.
- 2 The law should enable the quick, cheap and simple creation of a proprietary security right without depriving the person giving the mortgage of the use of his property.
- 3 If the secured debt is not paid the mortgage creditor should be able to have the mortgaged property realised and to have the proceeds applied towards satisfaction of his claim prior to other creditors.
- 4 Enforcement procedures should enable prompt realisation at market value of the mortgaged property.
- 5 The mortgage should continue to be effective and enforceable after the bankruptcy or insolvency of the person who has given it.
- 6 The costs of taking, maintaining and enforcing a mortgage should be low.
- 7 Mortgage should be available (a) over all types of immovable assets (b) to secure all types of debts and (c) between all types of person.
- 8 There should be an effective means of publicising the existence of a mortgage.
- 9 The law should establish rules governing competing rights of persons holding mortgages and other persons claiming rights in the mortgaged property.
- 10 As far as possible the parties should be able to adapt a mortgage to the needs of their particular transaction.

The language has been adapted to refer specifically to mortgage (for example, the person granting the security is referred to as the "mortgagor" and the person receiving the benefit of the security as the "mortgage creditor") but the substance remains unchanged.

The first principle is overriding: if the legal framework for mortgage does not lead to a reduction in the risk of providing credit and an increased availability of credit on improved terms, then there is no point in the law providing for mortgage at all. Every element of the legal framework should be analysed against this basic principle.

The trio of simplicity, speed and cheapness as emphasised in the second, fourth and sixth principles, is also fundamental and ties in directly with the concept of legal efficiency (see Part II). Every cost, irrespective of who bears it, that is involved in the creation of mortgage or its enforcement detracts from the benefits that mortgage provides. Any delays or complexities translate into additional cost.

The following parts look in more detail at how these principles apply and what they involve, first when mortgage is created (including registration) and then during enforcement.

2 Creation of mortgage – overview

Table 1 summarises what is typically involved in the creation of a mortgage in an efficient legal system. There are three basic steps:

- proof by the mortgagor that he owns (or will own) the property to be mortgaged
- agreement for the mortgage between mortgagor and mortgage creditor
- publicity of the mortgage through registration.

The creation of a mortgage is sometimes mystified as a result of a complex and formal process. It should actually be very simple as long as there is a clear understanding on these three basic steps, and in particular (i) what preliminary checks need to be made, (ii) what matters the agreement should address and (iii) the process and purpose of registration. The essential elements of each step are summarised below.

Proof of ownership

Proof of ownership covers the following areas of certainty.

- Certainty that the mortgagor has a mortgageable right in the property. A mortgage is an ancillary proprietary right that can only be given by the person with a principal proprietary right over the immovable asset which is most often established through title registration.
- Certainty as to the scope of the mortgagor's property. Any dispute over the scope of the mortgaged property will adversely affect the role of the mortgage as a credit risk mitigant. Title registration is usually based on a cadastral definition which needs to be both accurate and reliable so that the risk of a subsequent dispute is minimised.

Table 1
Steps for creating a mortgage

1. Proof by the mortgagor that he owns (or will own) the property to be mortgaged	
Property is defined in register	The register defines the location and exact boundaries and characteristics of the property, normally by reference to a cadastral map
Mortgagor's title is shown in register	The proprietary right of the mortgagor (or his vendor) is shown in the register against the property
Register shows all rights and claims	It shows any other existing mortgages It shows any other limitations to the mortgagor's proprietary right
Registered information is readily accessible to the public	All relevant information in the register is accessible to any member of the public Searching the register is cheap and fast (preferably via the internet)
Mortgage creditor can rely on the information in the register	It gives an accurate description of land It establishes the proprietary right of the mortgagor It indicates any opposable rights claimed by other persons
2. Agreement between mortgagor and mortgage creditor	
Defines the parties	Identifies the mortgagor and mortgage creditor
Defines the property	By reference to the description in the register
Defines the debt	Defines claim or claims that are secured by mortgage
Defines the commercial terms	Commercial terms relating to the mortgage may be in the mortgage agreement or other document May include security over related rights (insurance, rents and so on) Mortgage and credit may be covered in the same document
Formalities	Special requirements may apply regarding the form of the agreement and/or the manner of signature (i) to create the mortgage and/or (ii) to facilitate the enforcement of mortgage
3. Publicity through registration	
Application is made for registration	Application made by mortgagor or authorised person Defined information to be provided Documentation kept to a minimum
Checks carried out by registrar	Mortgaged property exists in register Mortgagor shown in register as holding proprietary right Applicant duly authorised
Publication in register	Mortgage is registered against the mortgaged property Registration is immediate Costs are low
Third parties are put on notice of mortgage creditor's claim	Mortgage opposable to all parties with priority ranking based on time of registration Any person searching the register can see the mortgage entry Searching the register is cheap and fast (preferably via the internet)

Note: The first column lists the basic elements of each step, the second column summarises what each element involves in practice.

■ Certainty as to any qualifications on the mortgagor's proprietary right. Immovable property can be subject to a variety of rights of third parties: mortgages or encumbrances, servitudes (such as a right of passage, occupation rights or rights of expropriation). In many cases these will be recorded in the title (or other) register. Where they are not, the law needs to define the extent and the nature of those rights (see Part III 3.2 c.).

Agreement for mortgage

The agreement defines the following:

■ the parties. (i) The mortgagor, that is, the person with a principal proprietary right over the property that is mortgaged. (ii) The mortgage creditor to whom the mortgage is granted. (iii) The debtor of the secured claim: in most cases this will be the mortgagor but sometimes one person will give a mortgage to secure someone else's debt. In this work it is generally assumed that the debtor is the mortgagor.

■ the mortgaged property. This will usually be defined by reference to the title register. The agreement may need to further define what is, and what is not, included in the mortgaged property – would, for example, the mortgage creditor be entitled to receive payment of rents? Does the mortgage creditor's right extend to all constructions on the land and equipment in the manufacturing plant?

■ the secured debt. This will include the principal debt and any interest. It may also include accessories such as costs.

■ other conditions relating to mortgage. It is usual to include rights and obligations of both the mortgagor and the mortgage creditor concerning the mortgaged property.

In many jurisdictions certain matters concerning the mortgage will be set out in the law and will not need to be expressly provided in the agreement.

Publicity of the mortgage

■ This is achieved through registration against the property, but without needing the onerous requirements involved in title registration, since the purpose is different (see Part III 3.5 c.).

■ It enables third parties, and especially those subsequently seeking to establish a claim, to discover that the mortgage creditor may have a prior opposable right in the mortgaged property.

■ It also establishes the priority between competing mortgages (most often based on the chronological order of registration).

The next part examines certain specific legal issues that can arise and make what could be a simple process unduly complex or inefficient.

3 Creation of mortgage – specific legal issues

3.1 Mortgaged property

a. Identification of property

Mortgages should be available over all types of immovable assets.¹ There is little justification to allow mortgage over some properties and not over others, and in practice few restrictions of that nature exist in transition countries (see Part IV 3.5).

One of the basic requirements for a mortgage is that the mortgaged property is identified with certainty and in a way which avoids any confusion with other property. Normally this will be done by reference to the cadastral description available from the land register. The absence of a reliable source from which to establish a unique identification for a property can present a significant problem when creating a mortgage. In practice this arises where some land or buildings remain unregistered, as is still the case, for example, in Croatia, Poland, Romania, Russia and Serbia. Much progress has been made in recent years and, with time and continuing efforts to centralise information, convert records into digital format, and make the database available to all via the internet, it is realistic to expect that in most transition countries records will become more complete and accurate, and information more readily accessible and reliable.

b. Constructions on land

It is also essential for the parties to be certain as to what is included in the mortgaged property. Most often constructions are included as part of the same property as the plot of land on which they are built and therefore would automatically be included in a mortgage over the land. However, in some jurisdictions (the Czech Republic, Kazakhstan, the Kyrgyz Republic and the Slovak Republic), buildings are treated as separate from the land

plot for purposes of ownership and registration, and it is then necessary to ensure that the description of the mortgaged property identifies not only the land plot but also any relevant construction on it. Problems can arise with later construction. If buildings are treated as separate, a mortgage lender could find it has a mortgage over the borrower's land plot and house, but not over a garage that has been built on the land subsequently. It is desirable that later constructions and improvements are automatically included in the mortgaged property unless otherwise agreed (see Part IV 3.5). This is of particular significance for builders and developers where a bank financing their projects will expect a mortgage not only over the land but also over new construction on the land as and when they come into existence.

Where a building is in multi-ownership (for example, apartments or condominiums) the proprietary rights in each unit will normally include co-ownership of, or other rights in, the underlying land and common parts of the building. If these rights are not properly established (often with a formal co-owners' association) or are unclear, the right to enjoy the property will be impaired with consequent adverse effects on the value of the mortgage taken on the property.

c. Financing future or unfinished constructions

Practical problems frequently arise with new construction. Property development is fuelling mortgage markets across transition countries and mortgage credit has a major role to play in encouraging the construction of new housing. Therefore, ways are needed for the land and future construction to be used as security for financing developments.

In practice the parties may want to commit to the sale and purchase of property before construction is complete, or even before it has started. This way the vendor (developer) reduces his risk and need for finance and the

purchaser is assured that he will obtain the residence he has chosen, which is particularly needed in markets where there is a shortage of new housing.

Without mortgage credit the newly developed housing market is effectively limited to cash buyers or those who can persuade the developer to accept payment after construction has been completed. In this case, banks would have their right of mortgage recognised only from the moment the borrower registers his property rights – in other words, when the construction is completed. If this option is not viable, and in many cases it is not, banks can try to resolve this problem by taking as collateral during the construction period the rights of the borrower under his agreement with the developer. In some jurisdictions a system of “housing certificates” is provided (a security offering the right to purchase a share in a building in construction, which can be traded and also pledged). However, lending remains risky since these rights may have little value if the construction is delayed or if the developer fails to deliver. In Russia, for example, the interest rate charged by banks on such loans can be between 2 and 3.75 per cent higher until the mortgage can be properly registered.²

The availability of mortgage finance for future or unfinished constructions can open up the market to a much wider range of buyers, but this also raises a number of special legal issues.

■ The construction will occur in the future: if the building does not yet exist the purchaser is relying on the contractual commitment of the developer to complete the building. Even if the purchaser is able to give a mortgage over the future property, security under it will only extend to the new construction to the extent that it ever comes into existence. It is therefore important that the borrower and lender assess and manage the construction completion risk.

Table 2
Land registers – availability on the internet

All basic information publicly available	Limited information publicly available	System under construction, not all information available	Information available to restricted persons	Not available
Czech Republic Estonia Hungary Latvia Lithuania	Ukraine*	Croatia Serbia Slovak Republic Slovenia		Bulgaria Georgia Kazakhstan Kyrgyz Republic Poland Romania Russia
England The Netherlands			Germany**	France

Notes: * Mortgage information is available but not title information.
** Only available to notary offices.

- The property does not yet have an identification (that is, a cadastral number): most acquisitions of newly built property will be of an apartment in a block of flats (also referred to as condominium). In that case, not only may the entire building not exist, but there may be no legally defined property for each individual apartment in the land or cadastral register that can be acquired. It is therefore necessary to examine (i) how the new property can be contractually defined, (ii) whether it is possible to register in the land register a property under construction on a provisional basis or subject to subsequent confirmation, (iii) what the purchaser is acquiring at the time of purchase (a mere contractual right, title to a future property, some kind of real right in developer's title, for example), and (iv) how a mortgage over the future property can be registered, either against the land plot on which the construction will be built in order to provide notice that, when the construction is completed, it will be already mortgaged, or against the construction's provisional title.
- The developer will often raise finance secured on the property being developed. That lender's commercial mortgage will cover the land on which

the construction is taking place and will also normally extend to any construction on it. Payments made by purchasers may be used to further finance the development and the mortgage given by the developer is unlikely to be released until a later date. It may be possible to take out a second mortgage in favour of the purchaser's bank, in which case it is necessary to define which part of the property the second mortgage covers.

d. What is included in the mortgage?

A mortgage creditor may expect his security to include items such as property insurance rights, fixtures and rents. It is important that there is certainty on the right of the mortgage creditor over the insurance proceeds in case of damage to the property. How this is achieved will vary from one jurisdiction to the next: typically it will be by agreement or by a provision of the law. In nine of the 17 countries covered by the Mortgage Regional Survey, the mortgage extends automatically to insurance claims. In Poland, it also includes a pledge of rents collected under commercial and residential leases. The parties need to be able to cover such items simply, with certainty and in a way that suits their transaction.

3.2 Title to mortgaged property

a. Who can grant a mortgage?

Any person with proprietary rights over a property should be able to grant a mortgage over it.³ In many jurisdictions this ability is qualified when the person is the state or the property serves a public function (for example, a school or hospital). For example, in Estonia and Russia mortgages over real property belonging to municipalities are prohibited. In the Slovak Republic, the prohibition only applies to assets belonging to municipalities that are used for public services. In each country a balance must be struck between the need to give protection to certain properties for reasons of public policy and the need for the state or local authorities to be able to raise finance by offering their property as security.

b. How to establish title

Before taking a mortgage the creditor will want to ensure that the person giving such security has good title to the property being mortgaged. In practical terms this usually means that he owns the property with all usual rights to use and transfer it, and that no other person has rights that might limit or prejudice his rights as owner.

The simplest way for the mortgage creditor to establish title is to consult the land register where the property and legal rights attached to it are shown in a way that can be relied on by third parties. Where the mortgagor is using the mortgage loan to purchase the property the creditor will want to ensure that the vendor has good title to the property and that it will be acquired by the purchaser at the time the mortgage is granted.

In transition countries, the task of establishing title is sometimes left to the mortgagor, who has to produce to the prospective lender a certificate of title over the property to be mortgaged. This may be a pragmatic way of reducing the burden on the lender when establishing title is time-consuming,

Box 2

The case of Ukraine

The Ukrainian 2004 Law on the State Registration of Property Rights to Real Estate and Their Limitations envisaged the registration of all ownership rights, including leases and mortgages in a consolidated register (referred to as the united register). It will supersede the Bureau of Technical Inventory where titles over finished buildings and constructions are currently registered, and the State Committee for Land Resources where titles over land are registered.

The united register has not yet started operating but despite this defective institutional environment, mortgage transactions are conducted relatively smoothly. This is thanks to the Information Centre run by the Ministry of Justice, which operates a number of fully electronic registries:

- the mortgage register, where mortgages are registered
- the Register of Prohibition of Alienation of the Immovable Property, where a mortgage creditor registers any prohibition in the mortgage agreement on sale of the mortgaged property
- the Register of Transactions with Real Estate, where leases of over 11 months are recorded
- the Register of Encumbrances, which records tax liens over immovable property.

These registers in effect provide the means by which mortgage creditors can simply, quickly and cheaply check, establish and protect their rights over the mortgaged property. Title risks, however, remain.

but checks are still needed to ensure that the certificate is correct and the mortgagor has to bear the costs of producing the certificate.

In much of the region of central and eastern Europe and central Asia, land registers are still not complete, centralised or easily accessible, and lenders have not been able to standardise their title investigations. Much progress has been made but work is still needed in many countries to complete the development of comprehensive, reliable and easily available information on land title, which is now found in some (but not yet all) developed economies. The ability in transition countries and in some western European countries to access land register information online is shown in Table 2 on page 15.

The aim should be to make it possible for title searches to be made directly by potential mortgage creditors on the

internet. This is already the case in the Czech Republic, Estonia, Hungary, Latvia and Lithuania. Lithuania is also a participant in the European Land Information Service (EULIS), which aims to provide electronic worldwide access to European land and property information by creating a platform connecting existing national land registers.⁴ Croatia and Serbia are working on an online land register but for the time being it cannot be relied on and creditors still need to go to the land register to check title. It is encouraging to see that the countries that provide online access generally make it available to any member of the public.

In former Soviet countries, establishing title is made more difficult because in the past, land and buildings have not been registered in the same register. Buildings were often listed in a so-called Bureau of Technical Inventory, whereas a Land Management

Committee was responsible for land records. Matters are further complicated by additional registers that existed for state-owned property only. Some countries, such as Moldova, have successfully merged these registers whereas others, such as Azerbaijan and Ukraine, have not. Also, records in the cadastre (where property is described) and in the land register (where legal rights are recorded) do not necessarily match (for example in Kazakhstan), and this means that before any mortgage can be taken, lenders may require clarification of discrepancies.

In the United States the risk of title defect or invalidity is habitually covered by title insurance – that is, an insurance policy covering a property purchaser (and his mortgage creditor) against the risk of defects in title. However, such a solution for transition countries is not necessarily appropriate. Unless the nature and extent of the potential defects can be clearly defined, the insured risk remains uncertain and the cost of insurance is likely to be prohibitively high. It is preferable for the reform of land registration systems (which is taking place in almost all transition countries) to ensure that reliable title information is shown in the register. Some countries have found pragmatic solutions to facilitate mortgage transactions pending improvements in land registers, for instance in Ukraine (see Box 2), and in Croatia where a mortgage can be created over a property not yet registered in the land register.⁵

c. Third-party rights in the property

The land register will usually show not only the ownership right but also the entitlement of other persons to rights in the property. The lender needs to know, for example, of all mortgages and other encumbrances, servitudes and easements, long-term leases and rights of occupation to be able to assess and value his security, and it greatly eases his task if he is able to rely on entries in the land register.

Registration needs to embrace all liens or encumbrances that have the effect of mortgage, including, for example, tax liens and judgment liens. It is not unusual that claims for taxes related to the property rank ahead of mortgage creditors when the property is sold but such claims are likely to be of limited amount. However, where a tax authority has obtained (by law or by court judgment) a right to pursue against the property for other tax claims (such as income or corporate tax, VAT and so on), this right needs to be visible in the same way as a mortgage for all to see because such a claim represents a significant risk to the value of the security.

The law may give spouses rights in each other's property. Where these arise from a general legal provision (such as in marital law) a mortgage creditor can be made aware of the potential existence of these rights from enquiries at the time of the mortgage application, and registration should not be necessary. It may be necessary to register these rights where they are not evident, for example from the marital regime (legal rules on marriage that relate to persons and their property) of the mortgagor. In Bulgaria, a right of use over the property may be granted by court order to a divorced spouse and this right would be enforceable against third parties, despite the fact that it is not registered in the land register. Such a "secret" right over the property can be problematic for mortgage lenders.

Although in transition countries the mortgagor has the right to grant several mortgages on their property, many mortgage lenders want to ensure that not only do they have first-ranking priority over the property acting as security but also that no lower-ranking mortgages can be created that might restrict their rights on enforcement. To achieve this, the lender may seek an undertaking from the mortgagor not to create further mortgages on the property (often referred to as a negative pledge). The rules applying to such undertakings and their effectiveness vary greatly from one country to the next (see Box 3 on

page 20), reflecting different policy standpoints. What is important is that the potential mortgage creditor is able to establish the position from the outset.

It is generally considered unduly onerous to require that rights of occupation be registered. The occupation of a property is often apparent from inspection and short-term leases are unlikely to be detrimental to the rights of the owner or mortgage creditor. Therefore the benefits of registration would be outweighed by the administrative burden that registration would entail. In the Netherlands, for instance, lessors have a right to stay in the property on enforcement, unless the mortgage agreement includes a clause limiting the right of the mortgagor to lease the mortgaged property, in which case the lease is deemed null and the property must be vacated. Where the rights granted to occupants are unusually extensive, they can become a disincentive to mortgage lending (see Part III 5.4 f.). The need from a mortgage creditor's perspective to have long-term lease rights registered depends on the nature of the right. In Lithuania, for example, only registered leases can be opposed to the enforcing creditor.

Rights registered after the mortgage has been created should not affect the prior right of the mortgage creditor. The principle of priority between mortgages being regulated by the time of creation is almost universally accepted. In some countries, such as Hungary, the Netherlands and the Slovak Republic, the law expressly provides that this priority order can be varied by agreement.

d. Restitution rights

In transition countries a particular case arises whereby former owners, whose property was nationalised or expropriated during the communist regime, have the right to have their property returned to them. What happens to the mortgage creditor who finds that title to the mortgaged property is removed from the mortgagor and passed to the former owner?

In practice, questions of restitution were largely resolved during the first decade after the fall of communism but the problem, although less acute, is still relevant. It is desirable that:

- any outstanding restitution claims are registered. In Croatia and the Czech Republic, for instance, restitution claims that have been lodged are noted in the land register against the property in question. In Poland, there is a special register of restitution claims held by the Ministry of Infrastructure
- the rules governing restitution are clearly defined so that third parties can assess the consequences of their applying to the property in question
- the mortgage creditor has a prior right in any compensation paid to the mortgagor.

More generally, on any claim affecting the mortgagor's title (whether restitution or otherwise), the mortgage creditor should be notified and should have the right to be involved.

3.3 The secured claim

a. Who can receive a mortgage and what types of claim can be secured?

In principle, a mortgage can be taken by any creditor.⁶ Attempts to limit mortgages to a particular category of creditors (for example, specialised mortgage lenders) are unusual. Rules may be applied to the activity of *mortgage lending* but there is no justification for reserving the use of mortgage as security to a restricted group of persons.

Mortgage should be available to secure all types of debt.⁷ In practical terms the debt has to be capable of being expressed in monetary terms. It may not be possible to directly secure an obligation to provide a service (for example, build a house). Enforcement of the mortgage would not make good any default in the mortgagor's obligation. However, it is possible to secure the monetary damage that is suffered because of default (such as the failure to build the house).

b. Nature of the debt

The nature of the debt that is secured and the way it is defined can be the source of many legal problems. The pragmatic requirements of the market are simple enough:

- there should be certainty between the parties as to what they have agreed
- the requirements for defining the debt should be simple
- there should be sufficient flexibility to allow the debt to be defined in a way that corresponds to the transaction that the parties want to carry out.

Certainty between the parties is normally required as a general principle of contract. However, requirements to specify and quantify the debt immediately at the time of mortgage creation are unnecessary and can greatly reduce the simplicity and flexibility of mortgage as a means of security. Certainty can be achieved notwithstanding a general description of the debt. The core requirement is that the description enables the debt to be determined with certainty *at the moment of enforcement* of the mortgage.

There can be much legal discussion on how to define a debt, where one debt ends and another begins, and what additional requirements are to be made when defining a debt for the purposes of security. Is each instalment under a loan a separate debt? Is interest part of the same debt as the principal? Should it be expressed as a money amount too? Likewise, theories abound as to whether a secured debt can fluctuate (as in the case of a bank overdraft or a credit line) and as to whether the secured debt can include future debts that arise after the mortgage is created.

These issues have already been well rehearsed, and often satisfactorily resolved, in the context of pledge laws (the securing of debt by movable property),⁸ yet they continue to present problems for mortgage (see Part IV 3.5).

Here it is sufficient to summarise the basic elements needed to achieve a simple and flexible definition of the secured debt.

- The secured debt may include debts arising in the future, for example further advances that a bank may make under a loan agreement, or additional loans that may be agreed subsequently. It should suffice for the description of the debt to make clear what is covered.
- The debt may also fluctuate, for example in an overdraft or revolving facility where repayments can be made and amounts redrawn subsequently.
- A general description should be possible. Formalistic requirements for specifying and quantifying each debt, for example listing each advance made by a bank under a loan agreement, are not needed to achieve certainty. In most cases the specific principal amount of the debt will be stated (typically in the case of a residential mortgage loan) but this should not be a legal requirement. In the case of a loan facility it is only the maximum principal amount of the debt that can be specified. In commercial and financial market transactions the principal amount may, for example, be calculated under a formula which gives sufficient certainty, but means that it is impossible to quantify the debt at the time the mortgage is given. Some countries allow a wide description of “all monies due from the debtor to the creditor”; others require that the legal nature of the debt is also specified. Frequently the maximum amount of debt has to be specified when a general description is used (see Part III 3.5. b.).
- The debt may include not only interest but also items as agreed by the parties (costs, commissions, and so on) and the costs of enforcement.
- The debt may be expressed in local or foreign currency.

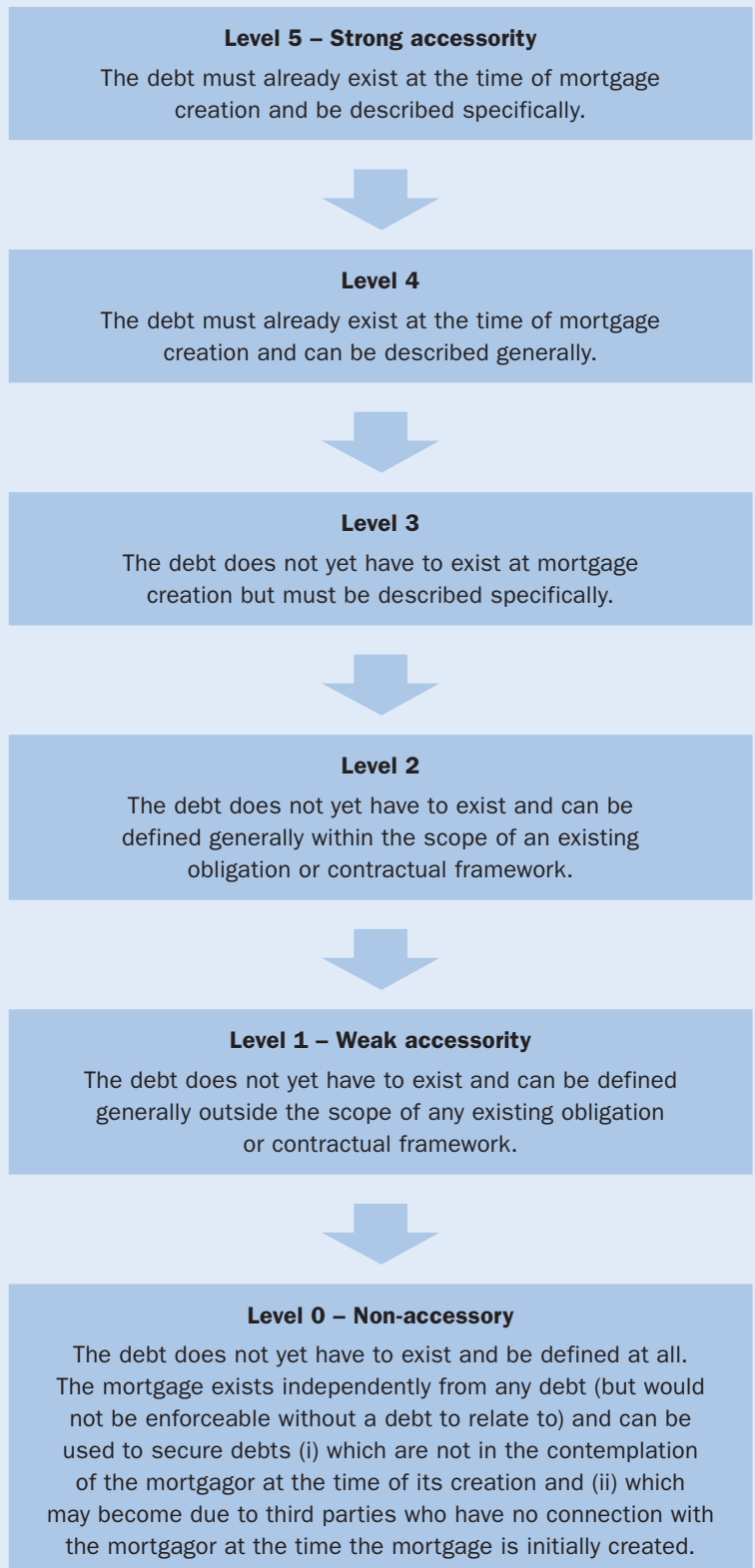
c. Accessory – should the mortgage be accessory to the secured debt?

Accessory is often cited as a curb on flexibility for mortgage creation and as an obstacle to the transfer of mortgage. These problems, in fact, do not come from the concept of accessory, which is self-evident: a mortgage always depends on the existence of a debt secured by a property, and in the absence of a secured debt a mortgage creditor can exercise no rights under it. In that sense there is no such thing as a “non-accessory mortgage”. While there is general agreement that the secured debt has to exist and be defined with adequate certainty for a mortgage to be enforced, requirements for the debt also to be in existence and/or specified *at the time of mortgage creation* vary considerably from one country to the next. Difficulties often arise from the way in which in some jurisdictions the so-called “doctrine of accessory” is applied. The requirements that result from such a doctrine can limit the kind of transactions that can be secured by mortgage and the way they can be structured.

Perhaps the easiest way to present the issues surrounding accessory is to illustrate the progression in terms of the debt that can be secured from what is sometimes called “strong accessory” through “weak accessory” to what is normally meant by “non-accessory mortgage” (see Chart 4 on page 19).

The non-accessory mortgage is often put forward as a solution to the problems that can arise from strong accessory. One of the best-known examples in practice is the *Grundschuld* (or “land charge”), which is successfully used for mortgage lending in Germany. It seems that one of the reasons why the land charge was developed by the banking sector was to circumvent problems under mortgages (*Hypotek*) when the interest rate was variable (as opposed to fixed). The land charge was then used instead of a mortgage: since it is created as an abstract security right, it could be used to secure debts that the mortgagor and the lender would define separately (and freely) by contract.⁹

Chart 4
Levels of accessory



The distinction between strong accessory and weak accessory is centred on the way in which the secured debt has to be defined and the moment at which it has to be specified. At one extreme, the debt has to exist and be fully specified at the moment the mortgage is created. At the other, it is sufficient at the moment of mortgage creation to describe the secured debt (whether present or future) with sufficient certainty to enable it to be identified specifically at the moment of enforcement of the mortgage.

As seen above, strong accessory poses practical difficulties in mortgage transactions because it can restrict the ability to secure debts described in general terms (such as variable interest rate) and to cover future debts. There are arguments rooted deeply in the legal traditions of some civil law jurisdictions of adhering to the strong accessory approach, for example that a right *in rem*, such as a mortgage, cannot be created without the debt being defined with absolute specificity. However, developments in recent years in the laws governing pledge in transition countries show that simple and legally efficient solutions can be found.

Decisions have to be made as to how far the law can be adapted to the needs of modern market practice or, on the contrary, how far the market should be restrained by legal principles that are mainly justified by doctrinal theory, rather than economic rationale.

Another argument sometimes put forward in favour of requiring strong accessory is the need to protect the debtor. A precise and specific definition of the secured debt is considered necessary to prevent the debtor being misled into giving security for more than initially intended. But there is little evidence of this perceived danger becoming a reality in countries that allow a general description of debt (including future debt). A feature that is increasingly common is to require the maximum principal amount of the secured debt to be defined in the mortgage agreement (see Part IV 3.5).

This reduces the risk of mortgagor and mortgage creditor having conflicting ideas on the extent of the security and, when the maximum amount is publicised, it increases transparency by providing information to other actual and potential creditors.

De-connecting the mortgage from the secured debt is also seen as a way of facilitating the transfer of mortgage loans. Since debt and mortgage are not linked, the formalities of transfer for the mortgage and the debt can then be dealt with separately. In countries where the formalities for the transfer of the mortgage are onerous, such separation may, it is argued, give scope for dealing with them more efficiently. Transfer of mortgage loans is examined in the section on mortgage securities (see Part V 4.1): it is evident that for securitisation it is desirable that mortgage loans can be transferred simply, quickly and cheaply. As with mortgage creation, the transition countries may choose to establish an inherently *efficient* system for the transfer of mortgage. If they do so, any advantage of the non-accessory mortgage on transfer falls away.

It has been suggested that the non-accessory mortgage be used as the basis for the Eurohypotheec.¹⁰ This derives from the difficulty of reconciling widely diverse systems operating in each of the 27 countries of the European Union without harmonising the existing regimes (which would be beyond the remit of the project of facilitating cross-border mortgage finance), and currently remains under discussion. When seeking a common form of mortgage to ease and encourage cross-border mortgage financing the non-accessory route may avoid some of the incompatibilities between existing national regimes. However, the legal efficiency of such a solution needs to be examined as a separate issue, as has been pointed out by stakeholders in the public commentary procedure on the European Commission Green Paper on Mortgage Credit in the European Union.¹¹

Box 3

Negative pledge clause – different views across the region

- In the Czech Republic, Croatia, Estonia, Poland, Serbia and Slovenia any contractual clause prohibiting a further mortgage over the mortgaged property is deemed void. This applies to third parties as well as between the mortgage creditor and mortgagor.
- In Hungary and the Slovak Republic, a negative pledge clause is possible between the parties but the prohibition of further mortgage over mortgaged property is not enforceable against third parties. A subsequent mortgage creditor would have a valid right in rem over the property despite the existence of the negative pledge. The prior mortgage creditor to whom the negative pledge had been given would have a claim in damages against the mortgagor.
- In Ukraine the law requires the consent of the prior mortgage creditor for the creation of any subsequent mortgage, so in practice a negative pledge clause serves no purpose.
- In Kazakhstan, Romania and Russia, negative pledge clauses are registered in the land register along with other mortgage information, and when this happens it is not possible in practice to register a subsequent mortgage.
- In other countries the effect on third parties is not clear.

Any discussion of accessory is made complicated by the different approaches and interpretations that apply from one jurisdiction to the next. And each lawyer will naturally tend to view the issues against the particular backdrop of his own system, which inevitably leads to crossed wires. But when the issues surrounding accessory are looked at detached from any specific legal system and are analysed in the context of the practical effect they may have on a mortgage transaction it becomes clear that the advantages of non-accessory may be illusory.

3.4 The mortgage agreement

The mortgage agreement is important because it defines the mortgage (security) that is being created and the parties' agreement in relation to it.

a. Content of agreement

The agreement must identify the parties, the property being mortgaged and the debt being secured. Beyond that it may contain other matters as the parties decide, including where appropriate

security over related rights (for example, insurance rights, fixtures, rents and so on). Parties should be allowed wide contractual flexibility.¹² Special rules may be considered necessary to cover matters such as negative pledge (see Part III 3.2 c. and Box 3) and *lex commissaria* (see Part III 5.2 a.) but detailed regulation of what the agreement can, and cannot, contain should be discouraged.

b. Form of agreement

In many jurisdictions the mortgage agreement is subject to the same requirements for form and signature as a transfer of real property. Generally, formal requirements should be kept simple and the costs low. The agreement needs to be in a form that gives adequate proof of the creation of the mortgage on any subsequent enforcement. In some jurisdictions a notarial deed is used for this purpose (see Table 3 on page 21). Where this is the case, the role of the notary needs to be well defined, as it should not duplicate the role of other parties, such as the registrar. The costs and

Table 3
Notarial involvement in the creation of mortgage

Notarial deed required	Notarial deed used in practice	Other compulsory notarial involvement*	No notarial involvement
Bulgaria Estonia Georgia Kyrgyz Republic Lithuania Poland** Romania	Croatia Hungary Slovenia	Czech Republic Latvia Ukraine	Kazakhstan Russia Serbia*** Slovak Republic
France The Netherlands	Germany		

Notes: * Usually signature certification

** Not required when the mortgage creditor is a bank

*** Signature certification must be done at the court

inconvenience of having a notarial deed should not be disproportionate and the benefits should be clear to the parties.

In some jurisdictions, mortgage certificates are also issued and registered in the land register at the same time as the mortgage agreement (see Box 5 on page 51).

3.5 Publicity of mortgage through registration

It is essential that a system is in place to publicise the mortgage.¹³ The value of a mortgage to a creditor lies in the confidence that the secured claim can be recovered out of the mortgaged property in priority to other creditors. Publicity of the mortgage ensures that any person subsequently acquiring a right in the mortgaged property is alerted to the existence of the mortgage. Likewise, when creating the mortgage the creditor can discover any pre-existing mortgages or other rights providing similar protection to the holder (for example, tax liens for unpaid taxes) that have a prior claim. Without a reliable system for publicity a creditor is unlikely to have sufficient certainty in his rights in the mortgaged property.

a. Where mortgages are registered

In most countries mortgages are registered in the same register as the title to the property and this helps the search process. Title to the property is already registered and the simplest system is to have mortgages registered against the title so that any person searching the title can see immediately the mortgages that have been registered. When the organisation of the title register is deficient a separate mortgage register can result in more effective publicity and more efficient searches (see Box 2 on page 16 for the situation in Ukraine).

b. Information to be registered

The amount of information that needs to be included in the register is quite limited. It is only necessary to note that a mortgage is claimed and the precise time of registration (since this will serve for determining priority between competing mortgages or other registered rights). Where registration is in the title register, the description of the mortgaged property and the identity of the mortgagor are already registered, but if registration were to take place in a separate mortgage register, this information would also need to be included.

It may also be useful to include:

- the identity of the creditor – this is almost invariably shown. It helps determine the mortgage with greater certainty and gives an initial indication of the person who is entitled to enforce the charge. It also enables any interested third party to enquire directly to the mortgage creditor about the mortgage and the secured claim. However, as will be seen below (Part V 4.1 d.), it is not desirable to make it obligatory to register any subsequent change of creditor (for example on assignment of the claim)

- the amount, or the maximum amount, of the secured claim – this enables any person – for example, a creditor considering a lower ranking mortgage – to assess the extent of the mortgage. The amount of the secured claim is registered in all countries covered by the Mortgage Regional Survey (apart from the Slovak Republic and the Kyrgyz Republic). The amount shown should be the *principal* amount of the claim excluding interest and costs. A requirement to quantify interest and costs should be avoided since it adds complexity with little practical benefit. Where the principal amount may vary (for example, a financing facility) it should indicate the maximum principal amount. This is the case in Estonia, Hungary, Latvia, Ukraine and the Netherlands.

Showing the duration of the mortgage is not recommended. The duration depends on the secured claim; whatever the contractual term for payment of the claim, the mortgage should continue until it is paid. Requiring renewal of registration after a given time has little justification (yet this seems to be required in Romania after 15 years, although there are conflicting views as to whether it would be compulsory; and in Bulgaria after 10 years). The onus and inconvenience of renewing registration outweighs any advantage of clearing redundant mortgages from the register, which should remain the responsibility of the parties. Negative pledge clauses (see Box 3 on page 20) are also sometimes registered.

c. Effect of registration

Traditionally, registration has the effect of authenticating the mortgage, guaranteeing its validity. In legal terms, registration often results in the creation of the proprietary right over the property. The aim of registering a mortgage is therefore to confirm to the world the validity of the mortgage in the same way as title registration confirms a transfer of land title. This approach derives from the principle that any person should be able to rely on the accuracy of information shown in the land register. However, in the context of the contemporary use of mortgage this approach is singularly inefficient: it means that the registrar (or another person, such as a notary, who is not a party to the transaction and on whom the registrar relies) must be satisfied that the mortgage is validly created. To be satisfied, he has as a minimum to check the mortgage agreement and the powers of the parties. It is this checking process that delays the creation of mortgage and means that it usually takes a number of days or weeks to obtain registration (see Chart 5).

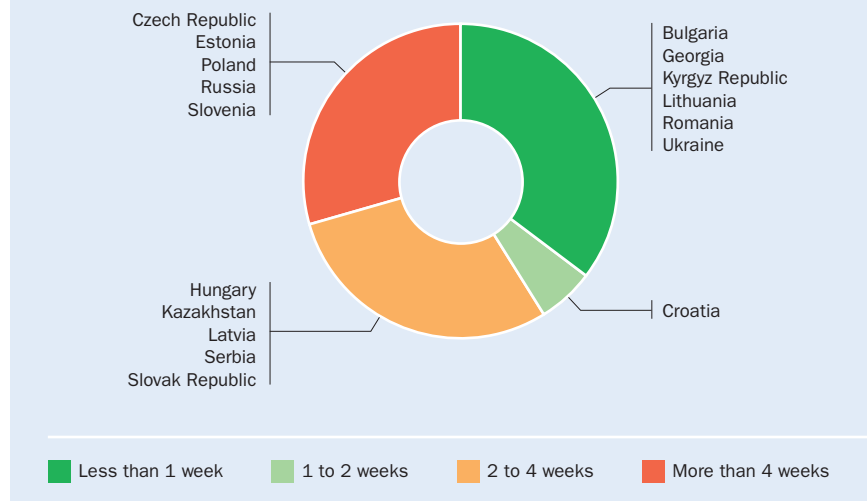
The case for the land register providing the public with guaranteed information on ownership of land is unquestionable, but the position for mortgage is different. The desired effects of registration of mortgage are:

- first, to alert third parties that a mortgage exists, or is claimed to exist;
- secondly, to establish the precise time from which it would have priority.

The validity of the mortgage is a matter for the mortgage creditor. He can establish the mortgagor's title to the property from the title register and he should be able to establish the validity of the mortgage agreement (in a similar way that he can establish the validity of the loan agreement). If the mortgage is enforced, which will only apply to a small fraction of all mortgages, any question of its validity can be raised at that stage in the same way as any question of validity of the loan

Chart 5

Average time taken to obtain mortgage registration



agreement. Requiring the registrar or any other external party to examine and be satisfied with the validity of every mortgage that is to be registered is placing a heavy and unnecessary burden on him that delays mortgage creation and is of little or no value to the parties or the public.

d. Registration process

To many the expression “registration process” still conjures up images of bureaucratic forms, arcane procedures, long queues, delays and costs. It should not. The process for registration should be designed to be simple and rapid. The requirements should be limited to what is necessary to achieve the intended effect. If, as in most traditional systems, registration is intended to “authenticate” the mortgage the process will be more onerous because the registrar will have to be satisfied either by his own enquiry or by relying on notarisation that the mortgage has been validly created. If, as explained above, registration is merely intended to publicise the *claim* of the mortgagor that he has created a mortgage, the registrar has only to:

- check that the mortgagor is registered as owner of the mortgaged property (see Part III 3.2 b.)

- check that the person requesting registration is the mortgagor or a person duly authorised by him

- ensure the information relating to the mortgage in the register accurately reflects the information given by the person who requested registration.

That process may only take a matter of minutes and now that most registers are becoming electronic the possibility of immediate registration is becoming real – not just the same day but “while you wait”. This is reported to be the case in Ukraine and in the Netherlands, where notaries proceed with mortgage registration directly from their own computer, accessing the mortgage register remotely.

The Czech Republic, Estonia, Hungary and Slovenia provide that the order of priority is the order of application for registration, and the order is preserved by an immediate note being made on the register of any pending application to register a mortgage. Useful as these procedures may be, they become unnecessary if registration is quasi-immediate.

e. Relying on registration

The extent to which third parties are able to rely on the entry of the mortgage in the register depends on the intended effect of registration. As explained above, if registration aims to “authenticate” the mortgage, then a third party will expect the entry to establish the right of the mortgage creditor under the mortgage, just as the register establishes the ownership right of the mortgagor. It has been seen that in practice this is not necessary. Leaving the onus of proving validity on the creditor who seeks to enforce simplifies the process for creating the mortgage and reduces time and costs. The mortgage creditor (and any person to whom the mortgage right is transferred) should be capable of ensuring that the mortgage is valid without having to rely on the registrar, and third parties only need to know whether a mortgage is *claimed* on the property.

A person searching the register does, however, need to rely on the fact that no mortgage can be claimed on the property other than those shown in the register. Reliance on the “negative information” given by the register is an essential element in establishing certainty of title (see Part III 3.2) and first-priority ranking.

f. Access to registered information and search process

The most important function of registration is to publicise the mortgage, to enable the public to discover that a mortgage is claimed. This information should be available to any person, without the need to demonstrate a particular interest. The search process should be simple, fast and cheap. The move towards electronic registries and the increasing use of the internet greatly facilitate the easy and immediate access to mortgage information and a relatively large group of transition countries have been quick at embracing the technological advances in this respect (see Table 2 on page 15).

4 Enforcement of mortgage – overview

What gives a mortgage its value, and therefore enables borrower and lender alike to derive benefit from it, is the confidence that it can be enforced, if necessary, to repay the lender's claim.¹⁴ The greater the doubts of the lender as to his ability to enforce, the less the influence of the mortgage will be when he decides whether to lend and on what terms.

Setting up an efficient basis for creating a mortgage is often easier than providing an efficient enforcement procedure enabling the mortgage right to be executed and the secured debt to be recovered out of the mortgaged property. Not surprisingly, many reforms have concentrated on the process of creation but it is feasible, and necessary, for a reform to address enforcement as well. In the context of mortgage securities (see Part V), investors will pay particular attention to the ability to enforce, since the value of their investment will depend to a large extent on the underlying mortgage loans, and the security rights attached to them.

Enforcement is dreaded as much by the mortgage creditor as it is by the mortgagor. When the mortgage loan is extended, both parties believe that the loan will be repaid, or the obligations fulfilled, as agreed. When difficulties arise the parties will usually undertake negotiations to try to resolve the situation in a way that is satisfactory for both sides. If the enforcement process is unclear, uncertain or inefficient, there may be scope for the mortgagor to evade his obligations and the creditor may be forced to compromise in a manner contrary to the original agreement. This puts a heavy onus on the law and institutions underpinning enforcement. It also means ironically that the better the system of enforcement, the less it is likely to be needed. Table 4 summarises what is typically involved in practice in the enforcement of a mortgage in an efficient legal system.

Table 4
Steps for enforcement of a mortgage

1. Establishing right to enforce	
Proof that secured debt is due and unpaid	Formalities are required to establish that secured debt exists Formalities are required to establish that secured debt is due and unpaid The extent of debt – a breach of credit or the mortgage agreement may lead to the whole loan becoming repayable or trigger the contractual right to accelerate
Opportunity to remedy	Time is given to the mortgagor to pay overdue amounts and/or remedy the breach
Right of mortgagor to contest mortgage creditor's claim	Appeal to court
2. Commencement of enforcement of mortgage	
Steps needed to commence enforcement	Notice given to mortgagor Notice given to other parties, such as other mortgage creditors Publicity (through registration) Grace period given
Proof that the mortgage is enforceable	Creditor declaration Executory title
Right of mortgagor to contest mortgage creditor's right to enforce	Appeal to court
Effect of insolvency/bankruptcy of mortgagor	May suspend enforcement May change procedure for enforcement
3. Realisation of mortgaged property	
Method of sale (or other means to generate proceeds) determined	Public auction, private auction, private sale, other How and when chosen Protection of other legitimate interests in the property
Realisation process	Who is responsible Duties to act diligently Prevention of abuse Timing
Repossession of property	Rights of the occupiers Eviction procedure
Priority ranking	Other mortgage creditors Other privileged creditors
Mortgagor's right to end realisation by repayment	
Effect of insolvency/bankruptcy of mortgagor	May suspend realisation May change process for sale
Title transferred to purchaser	How title is transferred No risk of subsequent challenge
4. Distribution of proceeds	
Procedure for receipt and disbursement of proceeds	Who is to receive proceeds and how Protection of legitimate claims of other parties Timing
Priority of the mortgage creditor	How this is established Claims of other priority creditors Priority should not be affected by a mortgagor insolvency/bankruptcy Any surplus funds go to the mortgagor

Note: The first column lists the basic elements of each step, the second column summarises what each element involves in practice.

For the enforcement of a mortgage there are three basic steps:

- establishing the right to enforce
- realising the mortgaged property
- distribution of the proceeds.

Realisation is the most visible step, since it determines the ultimate value of the security that the mortgage creditor took at the outset, but inefficiencies at any one of these steps can reduce this value.

When looking at each of these steps, the overall context of enforcement needs to be understood. It results from an agreement between borrower and creditor, and is intended to provide the means of assuring the creditor that he will be repaid even in case of default. It is not intended to enrich the creditor or to penalise the mortgagor.

By giving a mortgage, the borrower is reducing the lender's risk and therefore persuading him to lend (or to lend on better terms). However, as a result the borrower agrees that in the case of default, the lender can have the property sold to repay the debt. If the creditor exercises that right it should lead to realisation of the mortgaged property at, or very near to, market value. Any surplus from the secured claim should revert to the mortgagor.

Just as the mortgagor should allow realisation to take place and not obstruct the process, so also should the mortgage creditor be obliged to carry out enforcement with diligence and with a view to maximising the amount realised.

In modern practice there are various ways to protect the debtor, such as rules allowing time to remedy a breach or insurance cover that guarantees payment in case of ill health or unemployment. But a system that fails to recognise and implement efficiently the right of the mortgage creditor to enforce is depriving all parties of the full advantage of mortgage credit.

Establishing the right to enforce

Selling a property on enforcement is a serious measure and should not be carried out before a number of preliminary steps have been taken to establish that the right to enforce exists and that realisation can proceed. The precise nature of these steps varies considerably from one jurisdiction to the next, but broadly they involve establishing that:

- the mortgage creditor has a valid claim against the debtor
- the claim is secured by a valid mortgage over the property to be realised
- an event has occurred that entitles the mortgage creditor to enforce (and it has not been remedied)
- the mortgagor has been given notice of the intention to commence enforcement and has been given the opportunity to remedy
- the mortgage creditor has fulfilled all other conditions (often in terms of timing, notice, procedural steps and so on) for the realisation procedure to start.

Realisation of the mortgaged property

Realisation aims to generate money from the mortgaged property that will be used towards repaying the claim secured by the mortgage. This usually entails selling the property to a third-party acquirer, although in some cases the mortgage creditor may accept, at least initially, to derive only revenue from the property. What is paramount is that the realisation is conducted in a fair manner and that the proceeds of the realisation are maximised. Fairness implies that the mortgagor has the right to challenge the procedure but not in a way that is intended to deprive the mortgage creditor of his legitimate rights.

Distribution of the proceeds

Where the mortgage creditor is the only creditor claiming a priority right in the proceeds of the realisation, distribution should be straightforward, with any surplus returned to the mortgagor. Where there are other mortgage creditors or creditors with prior rights to the proceeds, there must be an orderly process by which the ranking order is respected. Where the mortgagor is insolvent, the insolvency procedure should allow the proceeds due to the mortgage creditor to be distributed promptly upon receipt. The rights of competing privileged creditors and their respective rank should have been determined well before the proceeds become available and therefore, even in a complex case, it should be possible for the proceeds to be distributed expeditiously.

5 Enforcement of mortgage – specific legal issues

5.1 Prerequisites to realisation: the mortgage creditor's obligations

a. Existence and validity of the secured claim and the mortgage

For a mortgage to be enforced it is necessary for the mortgage creditor to establish that there is a valid claim and that it is secured by a valid mortgage. In all jurisdictions rules exist as to what is required to prove that a claim exists and is valid. In the case of a bank loan this should be quite simple and should not involve onerous procedures. Establishing the existence and validity of a mortgage securing the claim requires confirmation that there is a valid mortgage agreement, that it has been publicised through registration and that it secures the claim that the creditor is seeking to recover.

Practices vary considerably but there are two issues which are often critical to the efficiency of the process: first, how onerous the formalities involved are and secondly the time in which they have to be fulfilled. The principle of simplicity should apply. Needless requirements should be avoided and a pragmatic approach is needed when determining the level to which the mortgage creditor has to actively establish proof of such existence and validity. Once the right to enforce has been established with relative certainty there comes a point when it is more appropriate to presume that the right to enforce is valid subject to any challenge by the mortgagor.

In many countries some of the formalities are carried out at mortgage creation, rather than enforcement. For example, in Bulgaria, the Czech Republic, Croatia, Estonia, France, Hungary, Germany, Kyrgyz Republic, Lithuania, the Netherlands, Poland, Romania, Serbia, the Slovak Republic, Slovenia and Ukraine, the mortgage can be created in a way that provides

“executory title”, whereby documents in the appropriate form (often a notarial deed) enable enforcement to be expedited, avoiding the need to apply to the court to issue a decision on the validity of the mortgage and secured claim. This can, however, lead to additional cost and complexity at the time of creation, which is hard to justify if it only serves a purpose in the relatively rare event of enforcement.

The arguments for avoiding formalities at creation that can be more efficiently fulfilled at the time of enforcement (should that ever occur) have been set out above (see Part III 3.5 c.). The same arguments apply when considering the formalities of executory title. The parties may choose to accomplish formalities for establishing executory title during the creation process but they should not be obliged to do so.

It is a delicate policy decision as to how far the creditor claiming the right to enforce should be obliged to produce supporting evidence for that right and how far the position of the mortgagor is adequately protected by his right to appeal to the court. The mortgage creditor should not have to demonstrate, through a complex or lengthy court procedure at the time enforcement is being envisaged, the existence and validity of the secured claim and mortgage. But it is equally important that the mortgagor, while being discouraged from obstructive behaviour, always has the right to challenge the validity of the claim and the mortgage via a court and that the courts are equipped to handle any such challenge (see Part III 5.1 c. and 5.4 b.).

b. Event of default

It is not only necessary for the enforcing creditor to demonstrate that there is a valid claim secured by a valid mortgage, he also has to show that the mortgage has become enforceable.

For a mortgage to become enforceable a trigger event needs to have occurred. This is normally a failure to pay but it may also be some other breach of

the loan or mortgage agreement. The trigger event needs to be linked to an acceleration of the secured claim so that the full amount becomes due. If the mortgage creditor enforces because the mortgagor has failed to pay interest or one instalment in the payment schedule, he wants to be able to recover the whole claim, not just the unpaid interest.

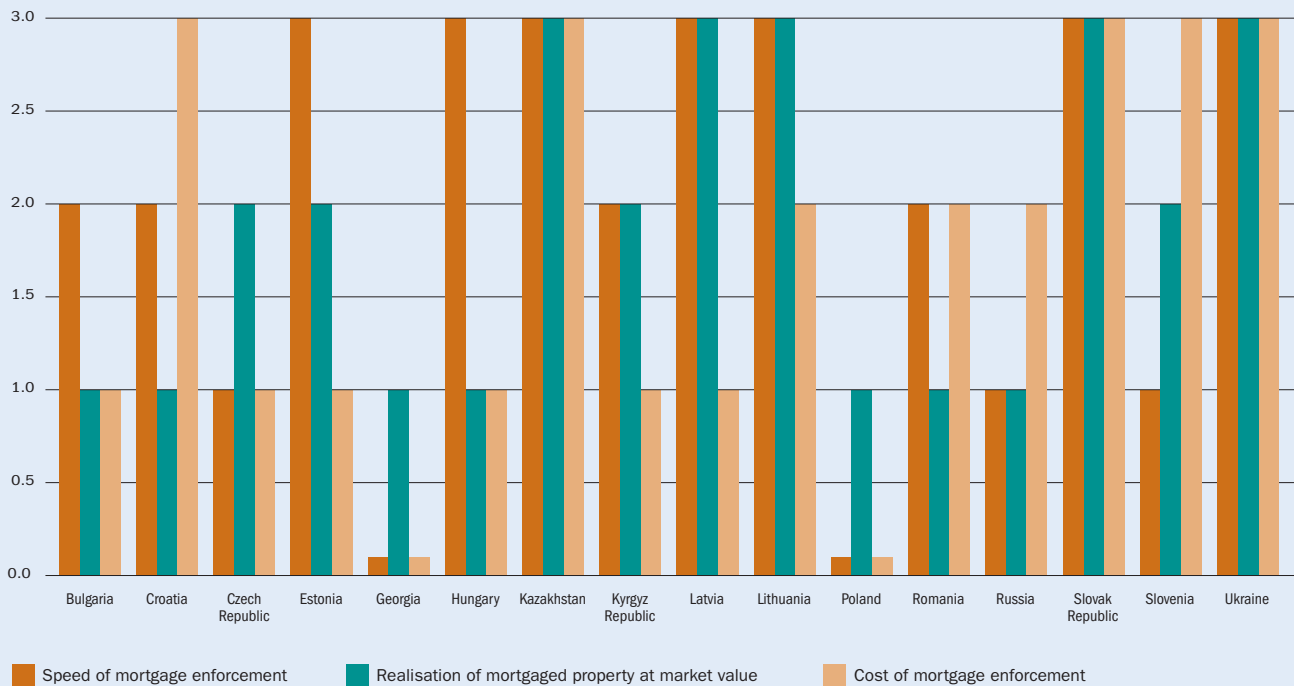
Acceleration may occur by operation of law but it may also be contractual. Typically a breach by the mortgagor will give the mortgage creditor the right to accelerate, leaving him the possibility, before exercising that right, to seek a less extreme resolution of the breach. Legal systems that limit contractual freedom may do so supposedly to protect borrowers but they send a dangerous signal about the underlying rationale behind enforcement. Again, the mortgagor should have the right to challenge the existence of the default through the courts (see Part III 5.4 b.). When determining the formalities that apply to prove default, similar considerations apply as for validity.

c. Need to involve the court

When the mortgage creditor enforces he is applying the procedure that has been agreed between the parties from the outset, and which was the basis on which credit was made available. There should be no mandatory requirement to involve the court. The mortgagor has the right to appeal to the court if he disputes the right of the creditor to enforce or the way in which he is executing that right. Likewise the mortgage creditor may seek redress from the court if the mortgagor tries illegitimately to prevent or obstruct enforcement. Similarly, if the mortgage creditor has grounds to fear that the mortgagor may try to evade enforcement, he may request the court to order preventing measures. However, in a straightforward case it should be possible to commence enforcement without any court involvement.

Chart 6
Efficiency of mortgage enforcement

Level of efficiency



Note: Data are based on the Mortgage Regional Survey (MRS), which asked the following questions: Is realisation of mortgaged property rapid? Is realisation likely to be at market value? Is mortgage enforcement inexpensive? Answers were graded according to efficiency ranging from 0.1 to 3, where 3 = very efficient, 2 = efficient, 1 = some inefficiency, 0.1 = inefficient. For more information see the MRS composite table in Annex 2. There are insufficient data for Serbia as the law is too recent for enforcement practice to have developed.

A full court review of the creditor's right to enforce should be reserved only for the case where the mortgagor requests it. Sanctions (such as damages and costs) should apply to a mortgagor who makes such a request without justification, and equally to a mortgage creditor who commences enforcement without being entitled to do so. Where there is compulsory court involvement for the commencement of enforcement it should be kept simple and fast.

d. Notice to the mortgagor

The mortgagor needs to be made aware of the mortgage creditor's intention to enforce. In a normal case the creditor will have already contacted the mortgagor in an attempt to obtain payment or remedy of any contractual

breach but when enforcement is formally commenced, notice is needed to ensure that the mortgagor is alerted immediately to the creditor's intention and to commence any grace period which may apply (whether imposed by law or contractually). Notice may also be required formally to accelerate the secured debt.

The requirements as to the form and content of the notice should be clear so that there can be no doubt as to its effect, but the formalities should be kept simple. Subsequent notices will be required as the enforcement procedure progresses (for example to advise the mortgagor of any sale and of the outcome) and it may also be necessary to give notice to other parties, such as other mortgage creditors.

e. Publicising the commencement of enforcement

Mortgage enforcement is relatively unusual; most mortgages are never enforced. So when a mortgage is actually enforced it is highly relevant information to third parties and any person examining the mortgage register should be alerted to it. The prospect of this happening may also be a practical incentive for the mortgagor not to prevaricate in performing his obligations.

On the other hand publicising enforcement is a serious step and it should not take place until the mortgagor has been given time to remedy or a fair opportunity to contest the enforcing creditor's claim. A mortgage creditor who publicises enforcement when he is not entitled to do so should be accountable to the mortgagor for damages.

5.2 Realisation procedure: incentives and obligations

Realisation of the mortgaged property can entail many different procedures but its objective is always the same: generating money from the property which will be used to repay the outstanding secured debt. If it is to be efficient, realisation should happen in a simple, fast and inexpensive manner and the proceeds should be close to the market value of the property.¹⁵ For a picture of the current situation in transition countries, see Chart 6 on page 27. The EBRD's approach has always been that there is no one-size-fits-all approach to enforcement and there is a need for the legal framework to adapt to the context and to give the mortgage creditor a choice of solutions.¹⁶

a. Method of sale

In many jurisdictions the traditional view has been that imposing detailed rules for the method of sale ensures a fair and satisfactory result. In particular, public auction has been promoted as the optimum solution, and often this is the only method of sale permitted with the process being closely regulated (for example, in the Czech Republic, Croatia, Georgia, Kazakhstan, Latvia, Lithuania, Poland and Romania). However, the results of enforcement through public auction do not in practice produce consistently good results (see Part IV 2).

The most suitable method of selling a property will depend on the market and the circumstances. For an unusual and highly desirable property, sale by auction may achieve the best price, whereas for a relatively standard property the auction process may put off potential acquirers. For a specialised production plant where interest is limited to a handful of market players, a closed tender may be the best way to sell. The interests of both the mortgagor and the mortgage creditor are that the property should be sold rapidly with minimum costs, and should

realise as near as possible to market value. The chances of achieving this are unlikely to be enhanced by restrictive regulation of the sale method.

It is preferable for the mortgage creditor to be given the right to choose the most suitable method of sale, either by law or in the mortgage agreement. The risk of the creditor abusing this right can be mitigated by ensuring that he is under a duty to act diligently and will be sanctioned for any failure to do so (see Part III 5.4 d.). It is sometimes provided that the parties can agree on the method of sale at the time of enforcement (especially to opt out from a court-led enforcement, for example, in Estonia, Russia and Slovenia), but this gives little comfort as the creditor cannot rely on obtaining such agreement. It is always open to the mortgage creditor to reach a separate agreement with the mortgagor, and indeed that may avoid formal enforcement happening at all. However, enforcement rules are there to cover precisely the case where the parties are unable to agree a mutually acceptable solution.

A case that is often regulated is the right of the mortgage creditor to appropriate the property for himself in satisfaction of the debt in case of default, without any sale procedure ("lex commissaria"). Since Roman times the law has discouraged this practice, which can clearly lead to the creditor profiting at the expense of the debtor. Most transition countries expressly prohibit it. This is the case in 15 out of the 17 selected countries, namely in Bulgaria, Croatia, the Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Romania, Russia, the Slovak Republic, Slovenia and Serbia. However, there is no reason why the mortgage creditor should not have the right to buy the property upon enforcement, subject to adequate safeguards to ensure that the price is fairly set.

Immediate sale may not always be the most effective mode of realisation: administration of the mortgaged property

by the mortgage creditor allowing him, for instance, to collect the rents generated by the property may, particularly in the case of commercial real estate, be a more effective option.

b. Who is responsible for sale?

The traditional view that realisation should be by auction is often linked with the view that the best institution to oversee the sale is the court. But the single most important issue on sale is to ensure that the price is maximised. The motivation of the persons who are responsible for the sale is likely to have a major influence on the outcome. The case for the mortgage creditor being given responsibility, subject to appropriate safeguards, for conducting the sale, or at least selecting the method of sale, is cogent and is being increasingly accepted. The court may have a role (in the background) to ensure that the sale is conducted fairly and that the rights of the parties are respected, but maximising the price is not a court's direct remit.

The sale of property is a market operation, essentially commercial in nature, and the best course is often to appoint external specialists to take care of the sale. The case for having those experts appointed by the court is open to debate. In some countries the procedures involved are bureaucratic and legalistic, the costs are high, and the motivation to achieve a rapid sale at a good price may be low (this was the case, for example, in Bulgaria where private bailiffs were recently introduced to help overcome the inefficiency of the court bailiffs).

Conversely, in the Baltic states and Slovenia, enforcement seems to work relatively efficiently despite court involvement (see Part IV 2 and Chart 6 on page 27). Whoever a country decides, in the context of its own institutions, to make responsible for the sale, the determining factor always remains whether they will be able to deliver a commercially acceptable result.

As well as being given the right to choose the method of sale, the mortgage creditor should also be entitled to appoint property professionals to conduct the sale for him, subject to an appropriate obligation to act diligently. A few countries in central Europe (the Czech Republic and the Slovak Republic, for example) have created a professional body of “private auctioneers”. By contrast to the “public auctioneer”, who acts on court orders and is subject to the full civil law procedure provisions, the private auctioneer is able to conduct public auctions in a way that is more flexible and generally faster and less bureaucratic. The existence of private auctioneers should not, however, exclude the right of the mortgage creditor to appoint any other person to advise him on the sale or to conduct a private sale on his behalf.

The responsibilities on sale should reflect the nature of the mortgage agreement. Mortgage is a private agreement and if enforcement becomes necessary it is primarily the duty of the mortgage creditor to organise the sale. He should be given wide scope to control how the sale is conducted and to ensure that the proceeds are maximised, not only in his own interests but because he owes that duty to the mortgagor and, indirectly, to the mortgagor’s other creditors (secured and unsecured).

c. Transfer of the mortgaged property to the purchaser

In realisation proceedings the purchaser needs to be assured that he will obtain as good a title in the property as that previously enjoyed by the mortgagor, free from the mortgage. The procedures for transfer and registration, and the authority of the mortgage creditor or other person selling to sign the necessary documents and take other steps, need to be clearly provided. The purchaser may be required to check that the mortgage creditor is

selling under enforcement procedures (for example by checking that commencement of enforcement has been registered in the mortgage register), but he should not have to verify the seller’s compliance with all relevant procedures.

The mortgagor’s rights to challenge the sale should cease at the moment the sale is completed, unless there are exceptional grounds, such as fraud or collusion between mortgage creditor and purchaser. Allowing a right to challenge the sale for a limited period after it is completed (for example for three months in the Czech Republic, Kazakhstan and Ukraine) may seriously discourage bona fide purchasers in enforcement proceedings. Many purchasers may not be prepared to take on the risk of the sale being later reversed for reasons outside their control. Ultimately this issue can have a major impact on the value of the security to the mortgage creditor.

5.3 Insolvency and bankruptcy

Should the mortgagor become insolvent or bankrupt, the ability of the mortgage creditor to commence enforcement – or pursue if the enforcement procedure has already started – is likely to be altered. Insolvency proceedings require creditor discipline and orderly liquidation of the insolvent debtor’s assets to ensure creditors are paid based on their respective rights. A temporary stay of proceedings is sometimes allowed to explore the possibilities of turning the business around (reorganisation). When individuals are involved, which is primarily the case in residential mortgage lending, personal bankruptcy rules should apply. These have yet to be developed in most transition economies but corporate insolvency laws have generally been modernised. Regardless of what the insolvency law provides, a number of principles should apply to avoid the mortgage losing its value as a security at the moment when the mortgage creditor needs it most.

a. Validity

The validity of the mortgage should not be affected by insolvency. If the mortgage existed and was valid pre-insolvency, this should continue to be the case post-insolvency.¹⁷

b. Setting aside

A mortgage may be set aside as fraudulent or preferential, or as carried out in the suspect period, but the applicable rules should be the same as those for other pre-insolvency transactions. There is no reason to treat mortgages in a harsher way.

c. Reorganisation

On a reorganisation or rehabilitation, the rights of the secured creditors may be temporarily suspended, but:

- rules on reorganisation and rehabilitation should aim to strike a fair balance between the interests of secured creditors and other parties
- suspension may be lifted if the mortgage creditor can show that suspension of the rights under the mortgage is not necessary for the reorganisation or rehabilitation
- the mortgage creditor should be protected from or compensated for adverse consequences of suspension (for example loss of value or deterioration of the property).

d. Liquidation

A policy decision is needed as to whether the mortgaged property will be included in the assets to be administered in the liquidation, or dealt with outside the liquidation. If the mortgaged property is outside the liquidation, the mortgage creditor will have a duty to the liquidator and/or other creditors to realise the property diligently and to account for any surplus (this is the same duty that exists towards the mortgagor prior to insolvency, see Part III 5.4 d.).

If the mortgaged property is inside the liquidation then it is necessary to:

- define who can enforce: it may remain as before the insolvency (mortgage creditor enforcement rights continue) but probably subject to the liquidator's authorisation, or it may be the liquidator only
- define the method of realisation: here again, the options are that realisation remains as before the insolvency or the same rules will apply as for realisation of other assets by the liquidator. In the latter case there is a need to define what happens where enforcement has already started at the time of insolvency and whether the liquidator would have the power to allow enforcement to continue
- include provisions enabling the proceeds to be released to the mortgage creditor as soon as is practical.

e. Preferential claims

A mortgage creditor should maintain a prior claim on the proceeds of realisation of the property (subject to the right of any pre-existing, prior-ranking creditor). Where preferential claims exist their scope should be defined with certainty and the potentially negative effect on the secured credit market needs to be carefully assessed. Countries that provide privileges to a group of creditors, such as employees, weaken significantly the economic role of the mortgage security.

5.4 Protection of rights and achieving fair balance

Realisation of the debtor's property – especially his home – to enable payment of his debts is an extreme solution, only to be used when other possibilities have failed. If the system for enforcement is to work efficiently there has to be a series of checks and balances. The mortgage creditor is often in the stronger position and it is easy to paint the picture of the creditor

who ruthlessly abuses his position of strength at the expense of the defenceless debtor. This overlooks the fact that the situation was born out of an agreement between the two parties, not by force or law. And the system that leans too far towards protecting the debtor may deprive the mortgage of much of its value, with consequent repercussions on the availability of mortgage credit.

a. Opportunity of the mortgagor to remedy

Realisation is the last resort and before it occurs the mortgagor should be given a fair opportunity to make good his failure to pay or other breach. Some laws provide for a grace period before enforcement can be pursued. In western Europe, this typically ranges between two days and two weeks, although in practice the period may be longer. Some transition countries provide a 30-day period, for example, in Kazakhstan, Serbia and the Slovak Republic. Any such provision should be designed to ensure that the bona fide mortgagor has some time to remedy, but without giving the unscrupulous mortgagor the possibility of protracting proceedings.

Even after the initial grace period is over the mortgagor should continue to have the right to stop enforcement by paying the outstanding debt. At this stage, however, the full amount of the loan may have become due (see Part III 5.1 b.) and the mortgagor may not be able to stop enforcement merely by paying the overdue instalments. In any event the mortgage creditor should be entitled to require reimbursement of the costs he has incurred in commencing enforcement. Once realisation has occurred the right of the mortgagor to remedy should cease.

b. Rights of appeal – role of the court

Throughout the entire enforcement procedure it should be possible for either party to involve the court if the circumstances merit it. The role of the court is important, but as a safety

net rather than a lead player. If the mortgage creditor leads enforcement either directly or through professional executors appointed by him, the court should be available to intervene at the request of either party if enforcement has not been implemented as agreed and intended. In particular, the mortgagor should have the right to apply to the court to challenge the right of the creditor to enforce, or if the creditor fails to respect his legal or contractual obligations on enforcement. The mortgage creditor should be able to apply to the court to challenge, or to obtain protection against, actions of the mortgagor that prevent or impede enforcement.

The court should be empowered to order appropriate remedies, such as a stay on enforcement, ordering the mortgagor to take necessary action to enable the sale of the mortgaged property to take place or to desist from obstructive actions. It should also be able to order either party to pay damages to compensate the other for the consequences of wrongful acts.

The role for the court is to put back on track a procedure that has derailed or gone against the parties' contractual agreement, *not* to take over the proceedings. The ability of the court to react promptly and to order appropriate remedies can be a determinant factor in the efficiency of enforcement. This may sound a very challenging role in transition economies where courts may have limited experience in arbitrating between parties in commercial matters and logistical difficulties in intervening swiftly. However, this is the objective to strive for.

c. Other mortgages – hierarchy of rights

Where there is more than one mortgage on a property the priority will usually be determined by the time of creation, although in some countries this can be changed by agreement. The competing rights of different mortgage creditors need to be regulated.¹⁸ The mortgage creditor with first priority should be

in a position to control enforcement. In practice an enforceable event on a subsequent mortgage is likely to make the prior mortgage also enforceable. The rights of subsequent mortgage creditors should be defined. If they significantly dilute the rights under the mortgage with first priority, this will encourage the use of negative pledge and thus reduce the possibility for the mortgagor to raise finance by further mortgages on his property (see Box 3 on page 20).

d. Duties of the mortgage creditor – incentives to maximise price

There can be many reasons why sales on enforcement frequently realise low value. Some of them have to do with the formalities and inefficient procedures involved but one reason is that the enforcing creditor may have little motivation to realise more than is necessary to pay off the secured debt. Requiring court supervision of realisation or imposing special auction procedures will not necessarily lead to a high price (see Part III 5.2 b.). On the contrary, if the mortgage creditor has been given a special advantage of being able to lead the enforcement process and choose the method of realisation, part of the quid pro quo should be that he is under a duty to act diligently and to maximise the price obtained. Failure to do so should lead to liability to the mortgagor in damages. The way that duty is framed will depend on the local legal context but it needs to be meaningful, similar to, for example, the duty that would be owed by a professional person who is commissioned to make a sale. At the same time it should be clear what the duty involves and care should be taken to ensure that it does not encourage opportunistic litigation. Where the mortgage creditor is required (or chooses) to appoint professional persons to conduct the sale on his behalf, those persons should be under a similar duty.

e. Duties of the mortgagor – cooperation and no obstruction

It is not just the mortgage creditor who has duties on enforcement. Realisation will normally require some cooperation from the mortgagor. It should be in the interests of the mortgagor to cooperate to achieve the best financial outcome. However, there need to be rapid and effective remedies if he fails to do so, for example if he acts in a way that could diminish the value of the property or prejudice the sale. The mortgagor who fails to cooperate or who actively obstructs the realisation process should also be liable to the mortgage creditor for the resulting loss or damage.

f. Rights of occupants

The occupants of the mortgaged property that is being sold may also need protection, because eviction of people (whether they are the mortgagor, his dependants or tenants) has important social consequences. However, the situation differs depending on the legal ground of occupancy.

- Where occupants have a valid lease on the property their basic rights under the lease will normally continue, although in some countries enforcement may give a right to the enforcing creditor to terminate the lease early. In some countries, leases that have not been approved by the mortgage creditor can be declared null (see Part III 3.2 c.).
- Where there is no lease a fair balance needs to be struck between social protection and the economic role of mortgage credit. If evicting occupants is a general problem for mortgage creditors as opposed to one that arises in specific, justifiable circumstances, this will discourage lending to a wider range of people, for example families with young children who are likely to represent a sizeable segment of the market.

Endnotes

- 1 See core principle 7, Box 1 on page 11 and Annex 1.
- 2 See Merrill Lynch, *Russian mortgage market*, February 2007, p. 13.
- 3 See core principle 7, Box 1 on page 11 and Annex 1.
- 4 Other participants are: Austria, England and Wales, Finland, Iceland, Ireland, the Netherlands, Norway, Scotland and Sweden. See www.eulis.org.
- 5 An authenticated statement of the putative owner's consent to creation of a mortgage is deposited in the Register of Deposited Contracts kept by local district courts. These statements are planned to be gradually transferred in the land register, once title issues have been resolved.
- 6 See core principle 7 in Box 1 on page 11 and Annex 1.
- 7 See core principle 7 in Box 1 on page 11 and Annex 1.
- 8 See EBRD Regional Survey for Secured Transactions at www.ebrd.com/st.
- 9 An analysis of the *Grundschuld* as used in Germany is beyond the scope of this work. Although it has been made to work successfully in Germany and is the principal instrument used in one of the largest mortgage markets in the European Union, it should be noted that the documentation required is more complex than in most jurisdictions where an accessory mortgage is used. See also O. Stöcker (2005), "The Eurohypotheck – Accessoriness as legal dogma?" in A. Drewicz-Tulodziecka (Ed), *Basic Guidelines for a Eurohypotheck*, Warsaw: Mortgage Credit Foundation.
- 10 See www.eurohypotheck.com, S. Nasarre-Aznar (2005), "The Eurohypotheck: a common mortgage for Europe", *The Conveyancer and Property Lawyer* (United Kingdom), January-February 2005, pp. 32-52.
- 11 The Green Paper focused on a number of issues mostly relating to the obstacles faced by lenders in one EU jurisdiction providing mortgage finance in another EU jurisdiction. The White Paper is expected to be published in December 2007.
- 12 See core principle 10, Box 1 on page 11 and Annex 1.
- 13 See core principle 8, Box 1 on page 11 and Annex 1.
- 14 See core principle 3, Box 1 on page 11 and Annex 1.
- 15 See core principles 4 and 6, Box 1 on page 11 and Annex 1.
- 16 See F. Dahan, E. Kutenićová and J. Simpson (2004), "Enforcing secured transactions in Central and Eastern Europe: an Empirical Study", *Butterworths Journal of International Banking and Financial Law*, Vol. 19, pp 253-257 and 314-318.
- 17 See core principle 5, Box 1 on page 11 and Annex 1.
- 18 See core principle 9, Box 1 on page 11 and Annex 1.

Part IV: Mortgage Regional Survey and comparative overview

1 Survey description

The Mortgage Regional Survey (MRS) was designed and compiled during 2006 and 2007, based on an analysis of the relevant legal texts, published information and experience of the EBRD, supplemented by information and advice received from practitioners in the relevant countries. The list of persons who contributed, to all of whom the EBRD is deeply grateful, is provided on page 2. The MRS has been developed in a similar manner to the regional survey of security over movable and intangible property, which was first published in 2000.¹

The MRS is intended as a tool for anyone interested in the modernisation, improvement or reform of mortgage law. It presents basic information and a comparative assessment of the legal regimes for mortgage in 17 transition countries, selected because either there already exists an active mortgage finance market or preparations for developing such a market are well advanced. The survey can be extended to other jurisdictions in the future. The questions address simple practical issues that highlight the strengths and weaknesses of the mortgage regime in each country in a way that may also be useful to credit providers and their advisers when assessing the potential value of mortgage security.

The MRS composite table is set out in Annex 2. It is the most convenient tool to consult when wanting to know the answers received on a particular question related to mortgage law, and the respective strengths and weaknesses of transition economies covered. If the reader's interest is limited to one country, it may be more practical to refer to the individual country tables.² Explanatory notes on the survey, including the criteria used for determining the grades on some questions, are set out in Annex 3. Less extensive research was also conducted on selected developed mortgage markets, namely England, France, Germany, the Netherlands and the United States, in order to look at the transition countries against a wider context (although making comparisons with the United States was not practical because of the differing systems that apply between individual states).

The questions in the survey are inspired more by market reality than legal theory. Based on the EBRD Core Principles for a Mortgage Law (see Annex 1), the survey covers four main areas of mortgage (creation, commercial effectiveness, effect on third parties and enforcement) and gives a reasonable indication of the extent to which these principles are upheld.

The MRS is not specifically designed as a means of measuring legal efficiency, but the information contained in it is easily linked to the criteria of legal efficiency (see Part II 2 and Chart 3 on page 9) and provides a useful starting point for such an exercise.

When commenting on the survey in this part, the questions have therefore been re-grouped according to the six legal efficiency criteria, that is: basic legal function; simplicity; speed; cost; certainty; and fit-to-context. For each criterion the survey grades have been used to indicate the relative efficiency of each country – there are four levels ranging from a clear yes to a definite no. We emphasise that these are intended as indicators of strengths and weaknesses, not as a comprehensive assessment.

The information covered by the survey is not comprehensive enough to provide a full assessment (especially for measuring fit-to-context) and a number of questions are relevant to more than one criterion. However, the results do provide a fair indication of what has been achieved in each country and useful pointers to what needs to be improved.

2 Basic legal function of a mortgage law

The basic legal function of a mortgage law is demonstrated by a number of key elements addressed in five questions of the MRS (see Annex 2 for the full table).

1.2 Is the manner of creation of mortgage clearly established?

3.2 Does mortgage give priority in mortgaged property?

3.3 Does the mortgage creditor have priority in bankruptcy?

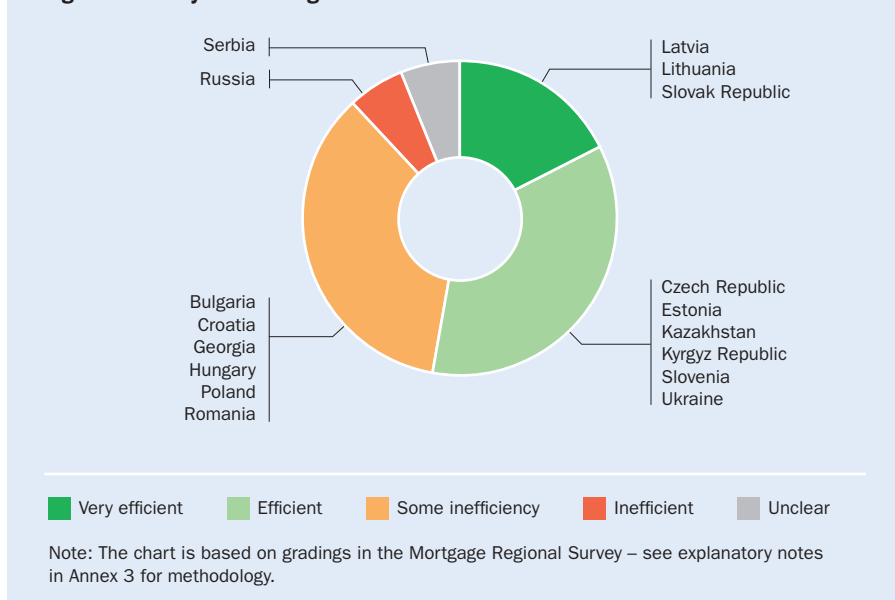
4.1 Is the manner of enforcement of mortgage clearly established?

4.4 Is realisation likely to be at market value?

It is encouraging to see that across all countries included in the survey the basic rules for creating a mortgage are clear and in almost all there is established practice. However, question 1.2 indicates the very basic position, and uncertainties arising from the law may lead to downgrades elsewhere in the survey. In Georgia, for example, while the overall creation process is established, some provisions of the law, such as the time of creation of the mortgage, are unclear.

Similarly, for mortgage enforcement the answers to question 4.1 indicate that at a basic level the manner of enforcement is clearly established. Where enforcement has to be carried out through the courts (which is the case in approximately half the countries covered by the survey, namely in Bulgaria, Croatia, Georgia, Latvia, Lithuania, Poland, Romania, Russia and Slovenia) there may be uncertainties concerning court procedure and practice. Even where enforcement is out of court such uncertainties are damaging since they weaken the fall-back position on which both mortgagor and mortgage creditor

Chart 7
Legal efficiency – basic legal function



should be able to rely. In Russia the enforcement process is relatively clear but the courts have a discretionary power to decide whether enforcement can proceed depending on whether it is considered “proportionate”. In the Kyrgyz Republic and Serbia there is as yet little practice of realisation on enforcement so procedures are not yet well established.

The answers to questions 3.2 and 3.3 show that there continue to exist some claims that take precedence over the right of a mortgage creditor outside the mortgagor’s bankruptcy (regardless of their date of creation), even where such super privileges no longer apply in case of bankruptcy (for example wages claims in Poland and Hungary). In practice it is not always clear how such claims would be enforced and to what extent they pose a significant risk to the mortgage creditor. In Russia, Croatia and Ukraine there is uncertainty as to whether tax claims may take precedence.

The priority position of the mortgage creditor on bankruptcy has greatly improved over recent years, especially in the case of legal entities. Wages and health and safety claims still have priority in some jurisdictions, such as Kazakhstan and Russia. The system of giving priority only to a proportion of the secured claim, which used to apply in the Czech Republic, Hungary and the Slovak Republic, now exists only in Georgia (although the new insolvency law is expected to abolish this rule). Tax priority is now generally limited to taxes on the mortgaged property (Croatia and Russia are exceptions). It should be noted that personal bankruptcy, where the mortgagor is an individual, is barely developed in the transition countries.

A country may have clear rules for creation, priority and enforcement of a mortgage but their usefulness is curtailed if the proceeds on realisation are not expected to be at or near to market value of the property. Gradings on question 4.4 have to be treated

cautiously. Information was derived from local practitioners and is to a large extent impressionistic since hard statistics are not available. Mortgage markets in the transition region are still far from fully developed and in most countries enforcement practice is still in its infancy. However, in four countries (Kazakhstan, Lithuania, the Slovak Republic and Ukraine), realisation is considered likely to be at market value. In Bulgaria, Croatia, Georgia, Hungary, Poland, Romania and Russia it is expected to be somewhere between 50 and 80 per cent of market value. In some countries booming property markets may have ensured that where enforcement has occurred, it has often been relatively easy to achieve satisfactory realisation. The robustness of mortgage enforcement procedures will only be truly tested when a downturn in the market leads to borrower defaults in less favourable

conditions. The Serbian Law on Mortgage, adopted in 2005, provides a complete new system of mortgage enforcement, clearly aimed at making the process more efficient, but there is not enough practical experience to be able to assess its results.

Taking the grades on the five questions that relate to basic legal function together, nine countries out of 17 score positively (that is, answer yes, even if that “yes” was qualified) on all questions (see Chart 7 on page 33). All of those that do not score positively fail on the value likely to be realised on enforcement. In addition, Russia fails to give first-rank priority to the mortgage creditor. As seen in Part III 4 and 5, improving the enforcement procedure is not always easily addressed and the gradings not only on question 4.4 but on all the MRS questions related to enforcement seem to confirm that this area needs attention in many countries.

3 Maximising economic benefit

The extent to which the mortgage law maximises economic benefit is shown for each criterion in key elements that are addressed in the listed relevant questions of the MRS (see Annex 2 for the full table).

3.1 Simplicity

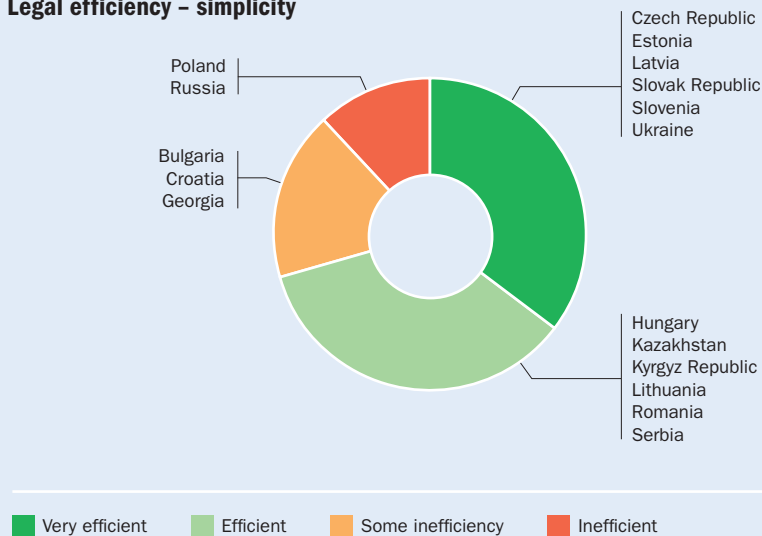
Simplicity is addressed in two questions in the MRS.

1.3 Is creation of mortgage simple?

4.5 Is enforcement procedure simple?

The creation of a mortgage, it has been seen, can be achieved by a simple agreement and a simple registration, but the survey shows quite a range of practices, some very simple and some complex. In Poland, a practice has developed whereby lenders require the creation of two mortgages: one securing the principal debt and a separate mortgage securing interest and accessories (*Hipoteka zwykła* and *hipoteka kaucyjna*, respectively). This complexity is due to the rigid approach towards defining the secured debt and doubts on the correct interpretation of the law.³ The registration process is often responsible for the downgrade in the area of simplicity because of complex or formal procedures, (as for example in Hungary, the Kyrgyz Republic, Poland and Russia) or onerous documentation requirements (as for example in Bulgaria, Kazakhstan, Lithuania and Russia). In Bulgaria, the Czech Republic and the Slovak Republic, multiple copies of the mortgage agreement have to be presented to complete registration. Although not sufficient by itself to make registration complex this is an example of an unnecessary administrative burden. Requiring a notarial deed is not per se an unacceptable complexity (see for example in Ukraine, which has established a simple process), as long as the benefits of such deed are clear to the parties.⁴ Generally the other aspects of creating a mortgage are

Chart 8
Legal efficiency – simplicity



Note: The chart is based on gradings in the Mortgage Regional Survey – see explanatory notes in Annex 3 for methodology.

quite straightforward. In Bulgaria there is a requirement to re-register a mortgage after 15 years and in Romania it seems there is a similar requirement after 10 years (see Part III 3.5 b.).

Enforcement of a mortgage, by its nature, is a more complex process than creation, but the law and institutions should not provide a system that is inherently complex. The realisation procedure is shown as relatively simple in a surprising number of countries (14 out of 17). In the three countries (Georgia, Poland and Russia) where realisation procedures were not rated as simple, the result of realisation was also shown to be well short of market value. In Poland, the procedures are formalistic and the operation of the bailiff system is reported to be highly inefficient, which is also reported to be the case in Russia. In Georgia, court practices can cause uncertainty among parties as to the correct enforcement procedure and likely outcome.

Complexity is often associated with the need to obtain a court judgment confirming the borrower's default and allowing for the mortgage's enforcement. Countries where the realisation procedure is simple generally apply either a simplified court procedure for issuing an executory title, as in Bulgaria

or the Czech Republic (see Part III 5.1 a.) or alternative out-of-court options such as a notarial stamp, as in Ukraine, or clauses in the mortgage agreement under which the mortgage creditor is granted a direct enforcement right in the event of default, as in Estonia, Latvia and the Slovak Republic.

Looking at jurisdictions in western Europe, the situation is also contrasted: the Netherlands has a straightforward procedure led by an authorised notary, whereas in France the procedure is complex. Looking at simplicity for creation and realisation together, 12 countries have the same grading for both questions and only two (Poland and Russia) have negative gradings for both (see Chart 8).

3.2 Speed

Two questions of the MRS deal with speed.

1.4 Is creation of mortgage rapid?

4.2 Is enforcement of mortgage rapid?

Taking a mortgage may take time because of negotiations between the parties or because it is linked to the acquisition of the property being mortgaged, but the creation of the

mortgage itself should not be the element that causes delay. If property searches are available online and registration becomes a notification procedure without authentication (see Part III 3.5 d.) it should be possible to carry out all formalities for mortgage creation within a day. However, the survey shows that this is not yet reality. In more than half the countries creation takes over two weeks, and in most cases the principal cause of the delay is registration. Chart 5 on page 22 shows the average time required for registration of a mortgage.

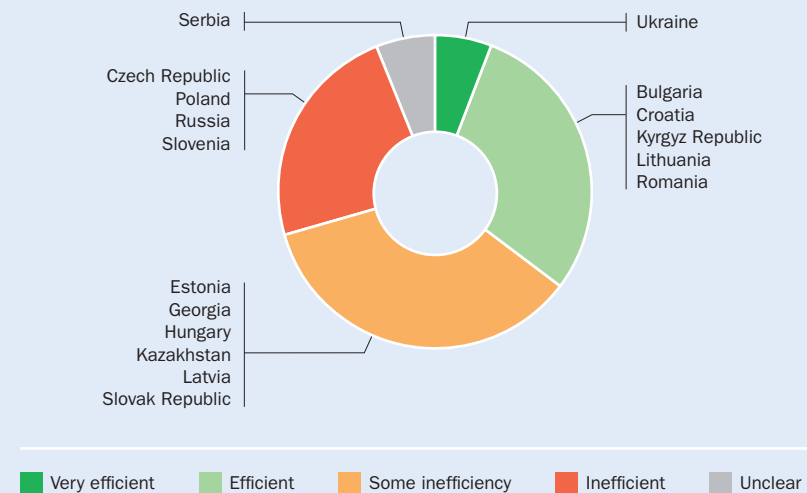
There are other causes of delay. In Estonia it is reported to take two weeks to obtain the requisite appointment with a notary, and in Kazakhstan title checks habitually take two to three weeks. In some countries it is frequent practice to advance a mortgage loan before registration formalities have been completed (for example in the Czech Republic, Estonia, Hungary, Kazakhstan, Poland and Serbia).

Where registration is delayed but there is little doubt as to the outcome then early disbursement of funds (that is, the mortgage loan) is an indication of the market finding a pragmatic solution to reduce the effect of slow or bureaucratic procedures. But where early disbursement is subject to the mortgagor providing insurance or additional security, as is the case in Poland, it indicates a more deep-rooted inefficiency.

The speed of enforcement is not as slow as it is sometimes perceived, especially when compared with the average time required in advanced markets. In seven countries out of 16 (there are no data on Serbia as the law is too recent for enforcement practice to have developed), enforcement is on average completed within six months, and in 11 countries it is completed within one year. Unlike creation, realisation on enforcement cannot become a virtually instantaneous operation. There are certain built-in delays, such as a grace period to give the mortgagor the opportunity to

Chart 9

Legal efficiency - speed



Note: The chart is based on gradings in the Mortgage Regional Survey – see explanatory notes in Annex 3 for methodology.

remedy before realisation commences, time for publicising the sale and time for the formalities of the sale to be completed. Completing the process within six months is commendable; few western European jurisdictions achieve that.⁵ Of the five countries where enforcement is reported to habitually take over a year (the Czech Republic, Georgia, Poland, Russia and Slovenia) all except the Czech Republic require – by law or in practice – realisation to be via a court-led public auction, and all except Georgia have a negative grading for the time taken for mortgage creation.

Chart 9 shows that, taking creation and enforcement together, more than half the countries have at least one negative grading (that is, show some inefficiency).

3.3 Cost

Here again, the question of cost arises at two points: creation of mortgage and its enforcement.

1.5 Is creation of mortgage inexpensive?

4.3 Is enforcement of mortgage inexpensive?

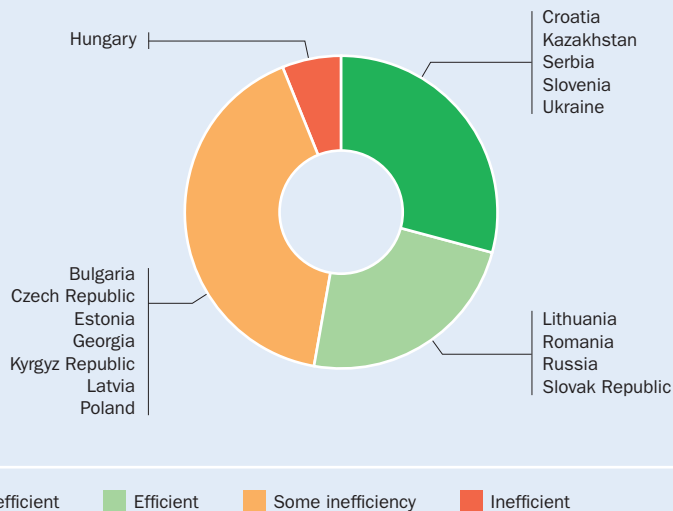
In most countries the cost of creation is not a significant problem. Hungary is the only country that is given a negative

grading for this as a result of the high notarial fees that generally apply (see Annex 2). Notary costs are sometimes denounced as excessive but a closer examination shows that in transition countries notary involvement does not always mean high costs. In Ukraine costs are low, despite the fact that a notarial deed is required. However, in the two countries where creation is shown as the least expensive – the Czech Republic and Russia – notarisation is not required. In Russia costs have fallen following the bold decision to lower notary costs (which used to be relatively high) and to repeal compulsory notarisation for mortgage.

The situation regarding the cost of enforcement is not as good. Almost half the countries indicated that enforcement costs (excluding advisory fees) amounted to more than 5 per cent of the amount claimed or the mortgaged property's value.⁶ Most often high costs are attributable to scale fees paid to bailiffs or public auctioneers.

The combined position on cost is shown in Chart 10 on page 37.

Chart 10
Legal efficiency – cost



Note: The chart is based on gradings in the Mortgage Regional Survey – see explanatory notes in Annex 3 for methodology.

procedure without predictable results, but this could not cover the case where children become occupants after the mortgage is created. This uncertainty is a deterrent to mortgage lending to young families.

Only four countries indicated difficulties with determining whether a property is mortgaged or otherwise encumbered. In Kazakhstan and the Kyrgyz Republic there are limits on publicly available information, in Bulgaria the way the information is registered can make it hard to find and in the Czech Republic tax liens on property may not be registered immediately. The progress being made towards transparency through online availability of land register information (see Table 2 on page 15) should make it increasingly easy to find out about existing mortgages. This is an area where many transition countries may be moving ahead of some of their western European neighbours. In France and Germany, a third party who wants to determine whether a property is mortgaged faces considerable difficulties.

Debtor obstruction to enforcement is to some extent a problem in every jurisdiction. There are recalcitrant debtors everywhere who will use all available techniques to frustrate a creditor's attempts to enforce, so it is not surprising that only four countries (the three Baltic states and Slovenia) report that obstruction is not a significant problem in practice. The situation is shown to be worst in Georgia and Poland, followed by Russia and Ukraine. In Russia debtors often apply for postponement, which can be granted by a court for a period of up to one year. A similar right to apply for postponement exists in Kazakhstan. In Georgia, the mortgagor and dependants are legally allowed after realisation to remain in the property if they choose to do so as tenants of the property purchaser.

During the enforcement procedure the purchaser is generally protected from any subsequent challenge that could be brought against his title to the property. In only five countries (the Czech

3.4 Certainty

Certainty is relevant to all aspects of a mortgage law but six questions in the MRS are especially relevant.

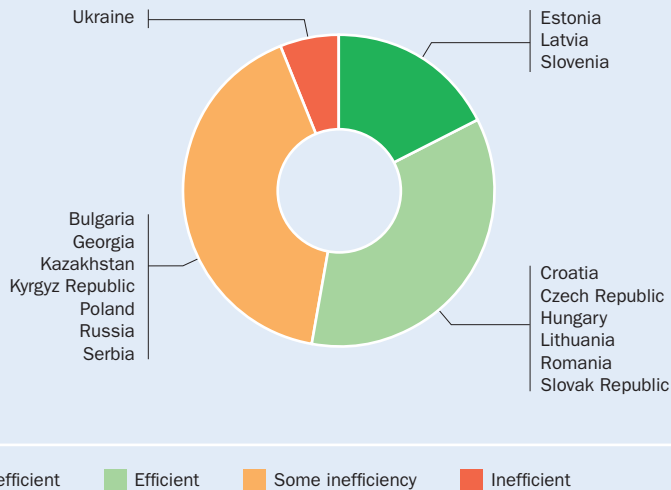
- 1.1 Can existing title to property be established with sufficient certainty?
- 3.1 Is the mortgage creditor protected from subsequent claims which may adversely affect the mortgagor's title to the property?
- 3.4 Can a third party determine whether property is mortgaged?
- 4.8 Is mortgage creditor protected against mortgagor obstruction?
- 4.9 Does commencement of enforcement have to be publicised?
- 4.10 Is purchaser in enforcement procedure protected?

In eight countries, establishing title to property does not cause significant difficulty. Only in Bulgaria and Serbia is a negative rating given, in both cases because of the unsatisfactory state of the land registration system. In general, countries have significantly reduced the amount of unregistered property but this is still a problem for several jurisdictions (Croatia, Poland, Romania, Russia and Serbia). Most countries

have unified their property records and use one comprehensive public register for all immovable property rights (see Part III 3.2 b.). In Lithuania the mortgage register is separate from the real estate register, but information entered in either is automatically fed to the other. Some countries, however, such as Kazakhstan, Serbia and Ukraine, have the relevant records registered in two or more registers, which can hamper the process of establishing title. Although great progress has been made in improving land registration across the region, the downgrades on this question mostly indicate reform that is not yet complete.

Subsequent claims adversely affecting title did not show up as a problem. There remains some risk of restitution claims on property but only in Lithuania, Romania and Serbia was there considered a significant risk that they could invalidate or restrict the value of the mortgage. In Ukraine lenders are concerned by a law designed to protect families with children, which makes eviction subject to approval from the Ministry of Youth Affairs. Mortgage loans are sometimes made conditional on receipt of such administrative approval, which can involve a lengthy

Chart 11
Legal efficiency – certainty



Note: The chart is based on gradings in the Mortgage Regional Survey – see explanatory notes in Annex 3 for methodology.

Republic, Hungary, Kazakhstan, the Kyrgyz Republic and Ukraine) can the mortgagor or a third party challenge the purchaser's title in the absence of fraud or exceptional circumstances. In the Czech Republic the challenge can be made only for certain defined reasons, and in Hungary if the sale was not conducted by a professional auctioneer or dealer.

Publicising the commencement of enforcement provides additional relevant and useful information to third parties. This is quite separate from the publicity of auctions, which aims to advertise the forthcoming sale (see Part III 5.1 e.). A note in the register against the mortgaged property is made in eight countries, although in Poland it is done by the bailiff and is sometimes late. In five countries there is no publicity. In four countries the publicity is limited: in the Czech Republic and Hungary publicity is only required where realisation is through the court (and in Hungary there seems to be no sanction for failing to publicise). In Russia and Slovenia publicity is only made after the court order.

The issue of certainty permeates most of the questions in the survey. Uncertainties have been noted elsewhere, for example, in the registration process, preferential claims and enforcement procedures. Similarly the answers to question 2.4 (form of debt) are commented on under “Fit-to-context” below, but for Bulgaria, Croatia, Georgia, the Kyrgyz Republic and Romania the requirements for describing the secured debt were reported as uncertain.

Chart 11 gives the composite picture for the gradings on five questions only. Although desirable, publicising the commencement of enforcement is not essential and therefore question 4.9 has not been included. With the exception of Bulgaria and Serbia all the negative gradings relate to debtor obstruction or purchaser protection on enforcement. Unlike the other charts on legal efficiency, this chart shows that uncertainty is more prevalent further east – whereas central European countries (except Poland) and Romania provide more certainty.

3.5 Fit-to-context

There are nine questions in the MRS illustrating the fit-to-context criteria.

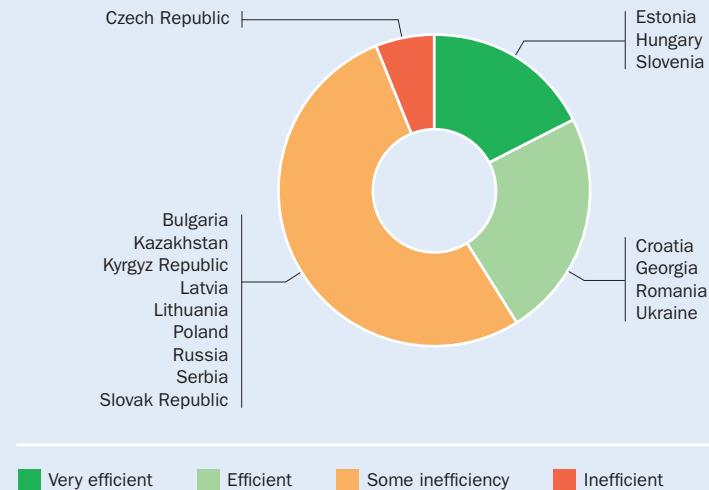
- 2.1 Can a mortgage be granted by any person?
- 2.2 Can any person take a mortgage?
- 2.3 Can the mortgage secure any type of debt?
- 2.4 Can the secured debt be in any form?
- 2.5 Can the mortgage cover all types of immovable asset?
- 2.6 Does the mortgaged property include subsequent constructions and additions?
- 2.7 Are subsequent mortgages permitted over same property?
- 4.6 Can the mortgage creditor decide on the way the sale will be conducted?
- 4.7 Can the mortgage creditor exercise control over the realisation process?

Questions 2.1, 2.2, 2.3 and 2.5 together reflect much of the essence of core principle 7: “Mortgage should be available (a) over all types of immovable assets (b) to secure all types of debts and (c) between all types of person”.⁷ The results are encouragingly positive. No country is given a negative grading on any of these questions. There are merely some reservations. In the Kyrgyz Republic and Ukraine there are restrictions on mortgaging agricultural land. In Romania mortgages under the Mortgage Lending Law can only secure loans used for investment in the mortgaged property (but this limitation does not apply to mortgages that are regulated by the Civil Code). There are no restrictions on who can grant a mortgage, and only minor reservations (in Croatia and Romania) on the person who can take a mortgage.

However, if one analyses more closely as to whether the secured debt can be in any form (question 2.4), an unqualified ‘yes’ grading is only received in Estonia, Hungary, the Slovak Republic, Slovenia and Ukraine. In eight countries requirements for specific definition of the secured debt restrict the ability to use a mortgage to secure

Chart 12

Legal efficiency – fit-to-context



Note: The chart is based on gradings in the Mortgage Regional Survey – see explanatory notes in Annex 3 for methodology.

future or fluctuating debts (see Part III 3.3 b. for details on what is expected of the legal system). In Latvia registration requirements effectively place limitations on securing foreign currency claims. Although these claims can be secured by mortgage, the amount secured is the Lat amount, which must be shown in the land register. In Slovenia “maximum amount” mortgages can be used to secure future and fluctuating debts but there are restrictions on their assignment. Intriguingly, in some countries the rules for defining the secured debt are different for mortgage than those applicable for pledge. For example, in Bulgaria, Lithuania and Poland following reforms of the pledge law, the secured debt for pledge can be in any form, whereas all these countries receive a negative grading on this question for mortgage.

Also if one looks specifically at whether the mortgaged property includes subsequent constructions and additions, problems come to light in seven countries (see Part III 3.1 b.). Buildings can be mortgaged but the division of title between land and buildings can give rise to practical difficulties. In the Czech Republic, Kazakhstan and the Slovak Republic

subsequent constructions on mortgaged land can only be included by way of a further mortgage. In Bulgaria, the Kyrgyz Republic, Romania and Serbia the position is unclear.

In all countries subsequent mortgages are permitted although their use may often be limited by negative pledge clauses, particularly in Kazakhstan, Romania and Russia (see Box 3 on page 20). In Ukraine consent from the prior mortgage creditor is necessary and in practice a prohibition to sell the property, opposable to all parties, is often registered.

In Hungary, Serbia, the Slovak Republic and Ukraine the mortgage creditor can decide on the way the sale is conducted and can exercise control over the realisation process (questions 4.6 and 4.7). In the Czech Republic, Kazakhstan and the Kyrgyz Republic the answer is also positive but subject to some limitation or doubt. For each country, with the exception of Romania, the gradings for questions 4.6 and 4.7 are similar. In Romania there is no choice as to the method of realisation (the law imposes a sale at public auction) but a bank can use its own enforcement officer to carry out the auction. Also in Bulgaria there is now

the possibility of appointing a private bailiff. In most countries there appears to be a direct correlation between the ability to choose and control the realisation process and the price obtained (question 4.4, see Part IV 2). Where such ability exists the recovery is good. But there are notable exceptions in the three Baltic states and Slovenia where, despite the lack of choice, the amount recovered is over 80 per cent of market value. In Hungary the inverse applies: the recovery level is low in spite of the mortgage creditor being allowed to choose and control.

It must be emphasised that the information covered by the survey does not adequately provide a full assessment of the fit-to-context legal efficiency criterion. It essentially only covers the questions on mortgage commercial effectiveness and the two questions (4.6 and 4.7) concerning realisation options for the creditor, which are omitted from Chart 12 since negative answers do not necessarily mean inefficiency. The survey does not, for example, indicate whether the mortgage law is compatible with existing market and legal practice, or whether it achieves an appropriate balance between fulfilling its economic purpose and ensuring that the effects of the reform are acceptable in context, or whether it achieves specific objectives for which it was designed. It is nonetheless interesting to see the composite picture for the seven questions covered (excluding 4.6 and 4.7) in Chart 12. The only negative ratings were on questions 2.4 (form of debt) and 2.6 (subsequent constructions). Three countries (Estonia, Hungary and Slovenia) have top gradings on all questions and most have one or two downgrades. Despite four downgrades, Romania is still maintaining a positive rating on all questions. It is also interesting to note that, if included in the chart, England, Germany, the Netherlands and the United States would all show as “very efficient” and France as “efficient” (because of a reservation on the form of the secured debt).

Table 5
Legal efficiency indicators – composite table

	Basic legal function	Simplicity	Speed	Cost	Certainty	Fit-to-context
Bulgaria	3	3	2	3	3	3
Croatia	3	3	2	1	2	2
Czech Republic	2	1	4	3	2	4
Estonia	2	1	3	3	1	1
Georgia	3	3	3	3	3	2
Hungary	3	2	3	4	2	1
Kazakhstan	2	2	3	1	3	3
Kyrgyz Republic	2	2	2	3	3	3
Latvia	1	1	3	3	1	3
Lithuania	1	2	2	2	2	3
Poland	3	4	4	3	3	3
Romania	3	2	2	2	2	2
Russia	4	4	4	2	3	3
Serbia	5	2	5	1	3	3
Slovak Republic	1	1	3	2	2	3
Slovenia	2	1	4	1	1	1
Ukraine	2	1	1	1	4	2

■ 1 very efficient
 ■ 2 efficient
 ■ 3 some inefficiency
 ■ 4 inefficient
 ■ 5 unclear

4 Legal efficiency indicators – composite table

It is not the purpose of the legal efficiency indicators table in this section to show winners and losers. The assessment methods are inevitably subjective and each country has to be viewed in its own context. However, Table 5, which brings together the six individual charts, gives a useful broad overview of the survey results.

Endnotes

- 1 See www.ebrd.com/country/sector/law/st/facts/survey.htm.
- 2 See www.ebrd.com/st.
- 3 See the EBRD report *The Impact of the Legal Framework on the Secured Credit Market in Poland*, July 2005, at www.ebrd.com/st.
- 4 See also Box 2 on page 16 for the registration system in Ukraine.
- 5 Based on a study by the European Mortgage Federation, only in Denmark and the Netherlands does the enforcement process usually take less than six months. Countries such as Italy, France or Greece are reported to sometimes require years of procedure (between 5 and 7 years, 10 months and 2 years; and 3 months and 2 years, respectively). For further information see European Mortgage Federation (2007), *Study on the Efficiency of the Mortgage Collateral in the European Union*.
- 6 In some countries costs are calculated as a percentage of the amount realised, in others as a percentage of the amount claimed.
- 7 See Box 1 on page 11 and Annex 1.

Part V: Mortgage securities

1 Mortgage securities in transition economies

Mortgage securities are a vast topic and this work aims only to give a brief overview of the legal basics and to highlight certain legal issues relating to mortgage, mortgage loans and pledge that merit particular attention. Historically there have developed two ways for a bank providing mortgage finance to use its existing portfolio of mortgage loans as a way of facilitating the funding of new loans. In Europe, particularly in Denmark and Germany, lending institutions have used the mortgage loans on their balance sheet as security for bonds that they issued to investors, and thereby obtained funding on more favourable terms than if they borrowed unsecured. The bonds issued, known as covered bonds (CBs)¹ are a means of secured borrowing, and often the legal framework for them is set out in special legislation. In the United States mortgage lenders have sold their mortgage loans (residential or commercial) to specialised agencies (for example, Fannie Mae), which fund their acquisitions by securitising the mortgage loans they acquire, issuing mortgage-backed securities (MBS) to investors. The risk attached to the mortgage loans is removed from the original lender's balance sheet and assumed by investors.

In recent years not only has the market for mortgage lending grown, but there has also been both a global surge in investor demand for high-grade debt instruments and an increasing trend for the segregation and transfer of risk.² Against that background the markets for CBs and MBS have grown and expanded geographically. The techniques used have become more complex and the distinctions between CBs and MBS blurred. For some CBs, MBS are eligible as collateral and for some MBS, CBs are eligible for the asset pool. Specialised and hybrid instruments have appeared in the markets, whether in response to investor demand or to accommodate legal or regulatory

Table 6
Covered bonds outstanding in Europe (selected countries)
in € million

	2003	2004	2005	2006
Czech Republic	1,638	1,956	4,452	5,543
Hungary	3,568	4,962	5,072	5,924
Latvia	35	54	60	63
Lithuania	0	14	14	14
Poland	160	220	558	453
Slovak Republic	370	792	1,235	1,861
France	21,079	26,816	32,133	43,012
Germany	256,027	246,636	237,547	223,306
Spain	57,111	94,707	150,213	214,768
Switzerland	20,735	20,606	21,670	23,096
Sweden*				55,208

Source: EMF – European Covered Bond Council.

Note: The figures show the volume of bonds covered by mortgage loans. In the period covered other transition countries do not seem to have issued CBs.

* In Sweden, the first CBs were issued in 2006, based on the 2004 Covered Bonds Act. Before 2006 only mortgage bonds were issued (outstanding volume at the end of 2005: €92.8 billion). As they are not directly comparable to CBs they are not included in the figures. A large part of the mortgage bond stock was also converted into CBs in 2006. The figures include both the converted bonds and the new bonds issued during 2006.

impediments, such as “structured” covered bonds, which are used particularly in countries where specialised legislation does not exist and which use elements of the structure used for MBS,³ collateralised loan obligations (CLOs), and “synthetic” mortgage-backed securities where the risk is transferred without transfer of the mortgage loans.

It is to be expected that markets will hone further the techniques for optimising the economic use of mortgage loans both through greater use of “classic” mortgage securities and through development of structured and hybrid products. In the European Union the structure of securities issued is influenced by the regulatory treatment for capital and investment purposes (see Box 4 on page 42).

To date, CBs have been more prevalent in the transition countries, although the total amount issued remains

comparatively small (see Table 6). They are a relatively straightforward and regulated way of improving the terms on which banks can obtain funding and they have been well tested in a number of western European jurisdictions.

MBS comprise a more complex product that provides scope for optimising the use of capital and managing risk. However, their advantages can only be fully enjoyed in more advanced markets where the required infrastructure is in place and there is confidence in the product. They may also transform the nature of the mortgage lending business, placing the emphasis on fee income and the financial gain that may be derived from the sale of mortgage loans. The recent financial crisis linked to the US sub-prime mortgage market may dampen investors' appetite for MBS in the short term, but it remains likely that MBS will be used increasingly in the larger and more advanced transition economies.

Box 4**UCITS and the Capital Requirement Directive (CRD)**

There are two EU directives that regulate covered bonds: the 1988 Directive on Undertakings for Collective Investments in Transferable Securities (UCITS) and the 2006 EU Capital Requirement Directive.

UCITS defines the basis for privileged treatment of covered bonds in European financial market regulation (article 22(4)). Covered bonds that comply with those requirements are considered safe investments and investment funds, such as pension funds, can invest up to 25 per cent of their assets in covered bonds of a single issuer that meet certain criteria (as opposed to 5 per cent otherwise). The 1992 EU directives on life and non-life insurance similarly allow insurance companies to invest up to 40 per cent in UCITS-compliant covered bonds of the same issuer.

The criteria are:

- the covered bond issuer must be a credit institution
- covered bond issuance must be governed by a special legal framework
- issuing institutions must be subject to special prudential public supervision
- the set of eligible cover assets must be defined by law
- the cover asset pool must provide sufficient collateral to cover bondholder claims throughout the term of the covered bond
- bondholders must have priority claim on the cover asset pool in the event of issuer default.

The 2006 EU Capital Requirement Directive, which is based on Basel II but adapted to the specificities of the EU financial markets, has established a privileged credit risk weighting for covered bonds if they comply with the following criteria (as provided in Annex VI, paragraphs 68-71):

- the covered bonds must comply with UCITS article 22(4)
- the asset pools that back the covered bonds must consist of only specifically-defined asset types and be of a certain credit quality
- the issuers of covered bonds backed by mortgage loans must meet certain minimum requirements regarding monitoring and regarding mortgaged property valuation (the ratio of the loan to the property's collateral value must be 80 per cent for residential mortgages and 60 per cent for commercial property).

Because of the higher costs and complexity, MBS transactions in transition countries have mostly been in the larger countries with a number of issues in 2006 and 2007 in Kazakhstan, Russia and Ukraine. Transactions were mostly structured off-shore, using an issuing vehicle located in a tax-neutral jurisdiction such as the Netherlands or Ireland. International financial institutions and bilateral organisations (such as the US Overseas Private Investment Corporation (OPIC), the International Finance Corporation (IFC) or the EBRD) have provided support to many of the transactions by purchasing subordinated tranches or providing guarantees. The first Russian onshore MBS took place in June 2007 when the Russian State Agency for Housing Mortgage Lending issued mortgage securities, with the EBRD purchasing a subordinated tranche of notes. There was also an MBS issue in 2004 covering the Baltic states. Romania and Poland have both adopted a legal framework for MBS but have not as yet seen any issues.

Mortgage securities are not solely for the benefit of mortgage lenders and professional investors. The ability of banks to issue mortgage securities has an impact on the entire property finance market and encourages the availability of competitive financing for any person wishing to purchase a home, or any business wishing to use immovable assets to raise finance. The appetite of institutional investors (including pension funds) for high quality debt securities is likely to provide an ongoing investor base for the market. However, as mortgage securities

become more complex, the need to understand and manage the risks becomes even more critical, and the role of rating agencies who give a credit rating to each issue (and on whom investors increasingly rely) becomes more important.

One element of the risk is the legal risk. The jurisdiction that wishes to maximise the potential economic benefits from mortgage securities needs to ensure that the legal framework (i) provides sufficient certainty as to what rules apply and how they will be applied, (ii) is hospitable to both CBs and MBS, giving market players the choice as to which instrument to use, and (iii) gives broad flexibility to enable parties to tailor the bonds or notes issued to the needs of their particular transaction and to adapt with future trends. A permissive legal framework does not preclude regulation of markets for monetary, consumer protection or other purposes.

Banks that have a portfolio of mortgage loans derive value from it through the income that the loans generate. However, as seen before, they increasingly want to make greater economic use of their portfolio and they can do this in two ways.

- By using a pool of mortgage loans as security for the bank's borrowings through CBs. Banks needing to fund their business seek better terms for that funding by offering the mortgage pool as security.

- By selling a pool of mortgage loans to investors who acquire the portfolio outright with all underlying credit risk through mortgage-backed securitisation. The bank frees up capital and can use the price paid for the portfolio for new business.

CBs and MBS are two distinct techniques. It is not a question of choosing to legislate for one or the other. An advanced economy should be able to accommodate both, and should allow mortgage lenders wide flexibility to use their mortgage loan assets in the way that best suits the market needs of the moment.⁴

Much has been written about mortgage securities.⁵ This part gives a broad overview of the legal framework that is needed for the issue of CBs and MBS and, in the context of transition countries, looks at specific legal issues that need to be addressed for mortgage securities to be used efficiently.

2 Legal basics – covered bonds

In essence, covered bonds (sometimes referred to as mortgage bonds) involve a mortgage provider issuing bonds to investors secured by mortgage loans. The mortgage loans remain on the mortgage provider's balance sheet (even where a special vehicle is used the bonds will usually be included in the issuer's consolidated accounts) and the legal structure is most often provided under specific legislation.

In the European Union the effect of the Directive on Undertakings for Collective Investments in Transferable Securities (UCITS) and the Capital Requirement Directive (CRD) is that most CBs conform to specific criteria (see Box 4 on page 42). These are likely to become increasingly accepted because the European Union has imposed a market standard and failure to comply with that standard will limit the attraction of a covered bond issue to the market. There will inevitably be many exceptions, as illustrated by the recent emergence of structured and hybrid products, and transition economies that adopt rules narrowly focused on EU conditions will be limiting the potential scope of the mortgage securities market.

Table 7 summarises the steps that are typically involved in an issue of CBs.

The key issues include:

- segregation of the mortgage loans from the issuer's portfolio that are to form the cover pool
- granting bondholders a priority right over the cover pool
- terms of the bonds and bondholder rights
- ongoing maintenance and monitoring of cover pool
- the effect of bankruptcy/insolvency of the issuer and/or the servicer
- regulation.

Table 7

Steps for the issuance of covered bonds

Create the pool of mortgage loans	Identify the loans (segregation, registration in cover register) Ensure the loans meet required standards (under the law, the UCITS and market criteria) Ensure uniformity of documentation
Give bondholders priority security right in the mortgage pool	By pledge or by special law Covers all rights under mortgage loans Continues on issuer insolvency Formalities required (form of pledge, registration) Repaid loans, and maybe doubtful loans, fall out and security extends to new loans that come in
Give bondholders priority right in cashflow from the mortgage pool	Payments under mortgage loans applied for servicing bonds (segregation, special bank account, pledge, escrow) Protected on insolvency
Issue bonds	The issuer must be authorised to issue bonds Terms of the bonds determined by law, regulation (for example, UCITS) and market criteria Bonds listed on stock exchange or other market Offer to investors including information on mortgage loans Bonds are freely tradeable securities (all rights under the bond pass to the acquirer)
Maintain pool and service loans	The issuer continues to service loans as before The cover pool is monitored for maintenance of criteria Sub-standard loans are removed (or discounted) and new loans are added
Maximise economic benefit	Capital treatment (UCITS and CRD) Rating agency criteria Tax Costs

Note: The first column lists the basic elements of each step, the second column summarises what each element involves in practice.

2.1 Segregation of mortgage loans

Segregation is important to identify the loans that are included in the mortgage pool. It is an identification process and does not affect the obligors of mortgage loans who do not need to be involved. Cover segregation happens in broadly one of four ways.

- All qualifying assets are automatically included in the cover pool, and the issuer can make periodic issues of CBs all covered by the same mortgage loans, subject to complying with an overall minimum cover requirement. Effectively the cover assets are segregated by legal definition and all CB issues of the same issuer share the same security. This is the system

that applies to Spanish cédulas as provided by the 1981 Law on the Regulation of the Mortgage Market.

- To include assets in the cover pool, the issuer has to register them in a general cover register, as for example provided by the German Pfandbrief Act, but there is only one such register so again all CB issues share the same security.
- To be included in the cover pool, assets have to be registered in a special cover register, which is created for a specific CB issue (this is the approach adopted in Ukraine). Here the security is not shared with other CB issues of the same issuer.

- Segregation is by transfer of mortgage loans to a special vehicle and the cover pool only secures issue(s) where that vehicle is used. This is the practice in the Netherlands and the United Kingdom, where the assets used as cover of the issue are specified in the sale agreement to the special vehicle and thus segregated from the other assets of the issuer.

2.2 Priority right of bondholders over the cover pool

The covered bondholders will receive a right to the mortgage loans in the cover pool ahead of all other creditors of the issuer. This may be achieved by a contractual pledge or by special law. The priority rights should extend to all rights of the issuer under the mortgage loans (including the mortgages) and the formalities required for creating the priority should be simple. In particular:

- it should be possible to extend the priority in such a way that it covers the whole cover pool (and any later additions) without the need for individual formalities for each loan and with sufficient certainty for the bondholders
- it should not be necessary to notify, or obtain consent from the underlying obligors (see Part V 4.1 a.)
- registration in the land or mortgage register should not be required (see Part V 4.1 d.).

2.3 Terms of bonds and bondholder rights

The bonds will most often be issued by the originator of the mortgage loans who will remain fully liable for all obligations under the bonds. The cover pool merely serves as security and reduces the risk attached to the bonds when compared with unsecured bonds of the issuer.

The cover pool should provide sufficient security for all payments under the bonds and the issuer will be obliged to maintain the pool to ensure that this remains the case throughout the life of the bonds.

Some terms of the CBs may be dictated by regulation, for example in the European Union the issuer will want to meet the requirements of the CRD and for investors it may be important that they meet the UCITS criteria (see Box 4 on page 42). It is usual for national laws providing for CBs also to specify terms of the bonds, for example that the outstanding amount of the underlying collateral, as well as its average maturity and interest payments, must be at least as high as all outstanding CBs.

Bondholders and the market will want information concerning the underlying mortgage pool in order to assess the strength of the security and the credit risk of the bonds. Normally this will be generic information and will not extend to personal information related to the individual mortgage loans protected by law or rules of banking secrecy (see Part V 4.5).

2.4 Ongoing maintenance and monitoring of cover pool

From the perspective of the obligors under the mortgage loans, it makes no difference whether CBs are issued. They continue to make payments to and deal with the original lender and there is no need for them even to know that their mortgage loans have been used to back an issue of CBs. However, from the perspective of the investing bondholders the ongoing servicing and administration of the cover pool is important for the quality of the cover pool. Often the issuer will continue to service the loans although the appointment of another company within the same group or third party is possible. What the bondholders will require in addition is a system which ensures that:

- payments under the mortgage loans are applied for servicing the bonds
- the cover pool is regularly monitored to check that the loans meet the relevant criteria (term, payment record, security cover, credit risk, and so on)
- loans that fail to meet the criteria are removed from the pool (or discounted) and replaced or topped up by new loans
- rights of the issuer under the loans are properly exercised.

This additional role may be filled by a special auditor appointed by statute, by an independent trustee or monitoring agent appointed under the terms of the bonds, or as part of regulatory supervision. In France, credit institutions appoint a registered auditor with prior consent of the banking regulator. In the Netherlands, the monitoring of the cover pool is performed by an independent auditor appointed in relation to that specific CB issue. The Spanish regime does not provide for special monitoring of the cover pool; it is checked within prudential banking supervision procedures conducted by the central bank involving regular disclosure of information about the pool assets. Similarly, in Denmark, the issuer's internal auditors are responsible for everyday monitoring of the cover pool.

2.5 Effect of bankruptcy/insolvency of the issuer and/or the servicer

The intention underlying CBs is to reduce the credit risk to the bondholders and it is essential that, if the issuer becomes insolvent, they have a prior claim against the cover pool ahead of other creditors. That prior claim needs to extend not only to the rights under the mortgage loans but also to the money payments made by the mortgage obligors to the issuer. If the issuer became insolvent it could be envisaged that the bonds may continue to normal

maturity without acceleration, with payments continuing to be assured by the cover pool. Under the 1997 Luxembourg Law, the creditors of *Lettres de gage* enjoy an absolute priority claim on the covered assets, which are separated from the other assets of the insolvent mortgage bank. The task to continue the servicing of the bonds is assigned to the supervisory authority, who may name another servicer – usually another institution that issues CBs.

Where a separate party is appointed to service the mortgage loans, protection will also be needed to ensure that the payments received under the mortgage loans are outside the servicer's bankruptcy or that bondholders have a prior right to them ahead of other creditors.

Although the bondholders should be adequately secured by the cover pool, the bonds remain obligations of the issuer and bondholders are entitled to claim any shortfall as ordinary unsecured creditors.

2.6 Regulation

If CBs are to be used efficiently the regulatory and taxation framework must be compatible, for example:

- the procedures for authorising the issuer to issue the bonds should be straightforward and without inappropriate requirements (for example, as to minimum capital)
- the capital treatment of the bonds will be important (see Box 4 on page 42)
- the procedures for offering the bonds to the public and the requirements for obtaining a public listing of the bonds on the relevant stock exchange should be clearly defined and appropriate
- any costs or tax charge arising out of the bond issue will reduce the economic advantage of using CBs and should therefore be kept to a minimum.

The market for CBs has to be properly regulated and supervised but avoiding unnecessary complexity, cost and delays arising from any regulation and supervision can, in practice, significantly affect the overall efficiency of the market, and hence the benefits it contributes to the economy.

3 Legal basics – mortgage-backed securities

In essence, MBS involve the sale by a mortgage originator and purchase by a special purpose vehicle (SPV) of mortgage loans which the SPV uses to support the issue of notes to investors. The proceeds from the note issue are used to pay the purchase price for the portfolio of mortgage loans. The mortgage originator is not liable for payment under the notes and the mortgage loans are removed from its balance sheet. Unlike CBs the risk under the mortgage loans is transferred from the originator to the investors.

Table 8 summarises the steps that are typically involved in an issue of mortgage-backed notes.

The key issues include:

- the nature and structure of the SPV
- the transfer of mortgage loans to the SPV
- terms of notes and noteholder rights
- ongoing servicing and administration of the mortgage loans
- effect of bankruptcy/insolvency of the originator and/or the SPV and/or the servicer
- regulation and tax.

3.1 Nature and structure of the SPV

The SPV needs to be an independent legal entity, bankruptcy-remote and separate from the originator so that:

- the originator or its creditors have no claim on the assets of the SPV
- the originator has no liability for the debts of the SPV
- the accounts of the SPV are not consolidated with those of the originator.

The SPV must have the ability to own mortgage loans and to issue notes. Its liabilities will be strictly limited to ensure that the only creditors entitled

Table 8
Steps for the issue of mortgage-backed securities

Create the pool of mortgage loans	Identify the loans (through segregation, and so on) Meet required standards (law, market criteria) Ensure conformity of documentation
Create the issuer (SPV)	Onshore or offshore Company or fund Separate from originator (no account consolidation, isolated from originator insolvency) Limited activity and limited scope for external creditors “Bankruptcy remoteness” protection from insolvency proceedings (limited recourse of creditors, non-petition covenants)
Transfer of the mortgage pool to SPV	Ability to assign loans (restrictions on assignment of customer loans, for example) “True sale” (no risk of recharacterisation) Covers all rights under mortgage loans including (i) right to enforce mortgage and (ii) insurance proceeds and other ancillary rights Opposable on subsequent insolvency of originator (problems of claw-back, recharacterising as not a true sale) Formalities required (form of assignment, registration in mortgage register) Entitlement of SPV to mortgage information Mortgage loans removed from the originator’s balance sheet
Give noteholders priority security right in mortgage pool	Pledge of mortgage pool by SPV Covers all rights under mortgage loans including (i) right to enforce mortgage and (ii) insurance proceeds and other ancillary rights The right continues on SPV insolvency Formalities required (form of pledge, registration) Entitlement to relevant mortgage information in case of enforcement
Give noteholders priority right in cashflow from mortgage pool	Protection against commingling Payments under mortgage loans belong to SPV (segregation, special bank account, escrow) Pledge of SPV rights over bank accounts and accounts receivable Protected on insolvency of originator/servicer
Give noteholders additional rights/protection	Ability to agree enhancement (hedging of currency or interest risk, liquidity facility, and so on) Pledge of additional rights/protection
Issue notes	The SPV must be authorised to issue notes Terms of the notes determined by law, regulation (such as UCITS) and market criteria Tranching (subordination, hierarchy of noteholder rights) Notes rated and listed on stock exchange or other market Public offer to investors, including information on mortgage loans Investor requirements (who can invest, how to market) Notes are freely tradeable securities (all rights under the notes pass to the acquirer)
Maintain pool and service loans	Originator may continue to service loans as before Ability to appoint third-party servicer (this requires full access to information, no need for consent from mortgagors and so on) Monitoring of mortgage pool (such as by independent monitor, regulatory supervision)
Maximise economic benefit	Mortgage loans removed from capital requirement calculations of originator Capital treatment for investors Rating agency criteria Tax Costs

Note: The first column lists the basic elements of each step, the second column summarises what each element involves in practice.

to claim against the mortgage loans are the noteholders. Offshore SPVs are often used, especially when there is little practice onshore or when domestic SPVs may not meet the necessary criteria. There is no overriding reason against using an offshore vehicle as long as there is adequate regulation and transparency, and any tax and currency issues are resolved. Many jurisdictions encourage the use of a domestic SPV by adopting specific legislation (for example in Bulgaria, Kazakhstan, Poland, Romania, Russia and Ukraine). However, insisting on a domestic SPV can be counter-productive, particularly if it is over-regulated, as it may not be suited to the particular transaction and may introduce uncertainty and complexity. The Italian 1991 Law No 52, for example, requires that the SPV is registered as a financial institution with the Ufficio Italiano Cambi, which can take up to 60 days.

3.2 Transfer of mortgage loans

For MBS it is not only necessary to identify and segregate the mortgage loans but also to transfer all rights under those loans from the originator to the SPV. The transfer needs to be a “true sale”; in other words, it needs to be a transaction that achieves a definitive transfer of the mortgage loans and whose nature cannot subsequently be re-characterised or challenged by any third party (for example, because of price adjustment provisions). Where a transfer by true sale is problematic, a “synthetic” solution is sometimes used to transfer the risk without legally assigning the mortgage loans.

The transfer needs to be simple and fast and should not involve unnecessary formality or significant expense and it should be possible to transfer a number of mortgage loans in a single document. The procedure for transfer can give rise to various issues, and in many countries is one of the principal obstacles to mortgage securitisation. These issues are addressed in more detail below (see Part V 4.1).

3.3 Terms of notes and noteholder rights

The notes will be issued by the SPV and their value to investors will depend on the certainty of the availability of the cashflow from the mortgage pool to service payments on the notes. The SPV will be structured so that the mortgage pool (together with any enhancement and hedging arrangements) are its only assets and its only liabilities are under (or related to) the notes. In addition, the SPV may give security over the mortgage pool (and the cashflow it generates) in favour of the noteholders, in the form of a pledge over the mortgage loans and the mortgage rights, for example, plus a pledge over bank accounts and future receivables.

As with CBs some terms of the notes may be dictated by regulation. For example, for investors in the European Union it will be important to meet the UCITS criteria (see Box 4 on page 42). It is usual for an MBS issue to be divided into several tranches, each with its own risk rating. Legal restrictions on the terms that can apply to securities, for example on the ability to achieve subordination of different creditor's rights, or uncertainty on the robustness of such subordination in the context of insolvency, may limit the scope for creating different tranches.

Noteholders and the market will want information concerning the mortgage pool in order to assess the credit risk of the notes. As with CBs this will normally be generic information, and will not extend to personal information protected by data protection law or rules of banking secrecy.

3.4 Ongoing servicing and administration of mortgage loans

The obligors under the mortgage loans need not be aware of the transfer of their loans to the SPV and the issue of the MBS. Often they continue to make payments to and deal with the original lender, who will act as servicer and continue receiving payments on behalf of the SPV. In some cases another servicer will be appointed, in which case mortgage obligors may have to be advised of the change in payment instructions (but not of the underlying reason for that change). Noteholders will require assurance that:

- payments under the mortgage loans are applied for servicing the notes
- the mortgage pool is diligently managed and rights of the SPV under the loans are properly exercised
- a professional person independent of the SPV will often be appointed to protect the interests of the noteholders (akin to a “trustee” in common law jurisdictions). In addition, regulatory authorities may be given a monitoring role.

The contractual right allowing prepayment of mortgage loans before contractual maturity and the resulting complications for the terms of MBS are sometimes raised as a legal issue. Mortgagors exercising that right may cause a cashflow mismatch between receipts under the mortgage loans and payments due on the mortgage securities. However, this is principally a market issue. There is a conflict between the interests of retail borrowers who expect a prepayment right before contractual maturity, and issuers of mortgage securities who wish to reduce it as far as possible, since the inability to predict when this right will be exercised may add complexity to the terms of the notes or adversely affect their pricing.

3.5 Effect of bankruptcy or insolvency of the originator, and/or SPV, and/or the servicer

Investors (noteholders) want protection from the bankruptcy or insolvency of any of the key parties to the MBS structure.

Originator

Noteholders will normally have no claim against the originator but they will need assurance that, if the originator becomes insolvent, a liquidator or administrator will have no grounds to challenge the transfer of the mortgage loans to the SPV, including preference, under value or interested party transaction or suspect transfer, nor will it have any grounds to claim a continuing right in the mortgage loans by having the transfer “re-characterised”, for example as a security arrangement, rather than an outright assignment (true sale). This issue, which again is key to the feasibility of securitisation in many emerging markets, is further developed below (see Part V 4.1 c.). Where the originator also services the mortgage loans protection will be needed to ensure that the payments received under the mortgage loans are outside the bankruptcy of the originator or that noteholders have prior right to them ahead of all other creditors.

The SPV

In principle the SPV will be structured in such a way that it should be “bankruptcy-remote”, with no risk of it ever becoming insolvent. Its obligations to noteholders will be covered by the mortgage pool (and any enhancement) and it should not have any other creditors.

In reality the position may not always be so simple and additional steps may be taken to protect against the risk of insolvency, such as:

- restricting the rights of individual noteholders to commence insolvency proceedings
- limiting the rights of other creditors to pursue for insolvency.

Servicer

Where a separate servicer is appointed the position is similar to that of CBs: protection will be needed to ensure that the payments received under the mortgage loans are outside the servicer’s bankruptcy or that noteholders have prior right to them ahead of other creditors.

3.6 Regulation and tax

The requirements for a compatible regulatory framework are similar to those for CBs, including:

- the procedures for setting up the SPV, enabling it to have mortgage loans transferred to it and authorising it to issue the notes should be straightforward and without inappropriate requirements
- the accounting treatment should reflect the transfer of risk from the originator to the SPV
- the capital treatment of the notes for investors will be important (see Box 4 on page 42)
- the procedures for offering the notes to the public and the requirements for obtaining a public listing of the notes on the relevant stock exchange should be clearly defined and appropriate.

As with CBs any costs or tax charge arising out of the issue of the notes will reduce the economic advantage of the transaction and should therefore be kept to a minimum. The scope for tax complications in MBS structures is greater and it is usually important to ensure that the effect of using an SPV is tax neutral.

Again, proper regulation and supervision is essential but an efficient market for MBS can only be developed if unnecessary complexity, cost and delays are avoided.

4 Specific legal issues

It is clear from the overviews above that mortgage securities are complex instruments that can be affected by a host of legal and regulatory issues. They can only be used effectively if investors can be convinced that there is a sufficiently robust legal framework not only for mortgage but also for the issue of securities, for the transfer and pledge of mortgage loans and other assets, for insolvency and for enforcement of creditor rights. To quote from a World Bank policy research working paper:⁶

“The sheer difficulty of developing infrastructure is one reason why there has been only limited success in introducing mortgage securities in emerging markets. The legal and regulatory complexities of mortgage securities and specialized institutions are formidable even in sophisticated developed economies... . It is the case that many pieces of the puzzle have to be put into place before a picture emerges and in a number of countries, the introduction of mortgage securities is still a work in progress.”

It is far beyond the scope of this work to attempt to cover in detail all the issues that have to be addressed in order to put in place a legal and regulatory framework for mortgage securities. As a practical (but not a legal) matter, standardisation of mortgage loans is essential for the efficient use of mortgage securities.⁷ Here, however, we dwell on certain aspects of law and regulation affecting mortgage, mortgage loans and pledge that can be critical for achieving the necessary flexibility and legal efficiency to make mortgage securities viable once the rest of the framework is in place and the market players are ready to seize the new opportunities.

These aspects are:

- the transfer of mortgages and the loans they secure
- the pledge of mortgage loans and ancillary rights

- payments and ongoing servicing of mortgage loans
- the right of the SPV to enforce the defaulting mortgage loans
- confidentiality of information.

4.1 Transfer of mortgages and the loans they secure

In the case of MBS, transfer of the mortgage loans is, from a legal standpoint, probably the most important feature. In most cases the mortgage transfers with the loan. It is essential that the conditions for transfer are clear, not onerous and involve minimum costs. As clearly expressed by the European Securitisation Forum:

“Credit risk of assets must be divorced from the credit risk of the originator of those assets. To achieve this, rules relating to the sale, transfer and isolation of assets should be certain and not such as to leave the credit risk with the originator following sale. Provisions relating to sale and transfer should not be onerous, time-consuming or expensive. Originators must be able to retain or create specified and limited risks and/or retain the right to economic benefits on the assets without prejudicing the sale, transfer and legal isolation of such assets.”⁸

a. Consent from mortgagor⁹

A loan is a financial asset which should be tradeable as any other asset. In modern practice the nature of the relationship between a lender and a mortgagor-borrower rarely falls into the special personal category that merits restrictions on transfer. The effect of the assignment is only to transfer the rights of the lender under the loan and mortgage. The lender remains liable for performance of any continuing obligations. Any legal requirement for obtaining borrower consent subsequent to the time of the mortgage loan should be strongly resisted since this will almost inevitably endanger the viability of potential MBS transactions.

This seems to have been well understood in transition countries, where no country requires mortgagor consent to enable the transfer of a mortgage loan. There is, however, some uncertainty in this respect in Russian law, which provides that if the identity of the creditor (originator/lender) is of importance, an assignment can only be made with the obligor’s (the mortgagor’s) consent. However, experts report that there is no conclusive position as to when the identity of the originator will be of importance for the obligor.

b. Notice to mortgagor

Similarly any requirement to give notice to the mortgagor, although less onerous since the transaction does not depend on obtaining consent, is likely to impose an additional burden and cost, which are best avoided. Again, it is the position in most of the transition countries covered in this work that notice is only required in order to make the transfer opposable against the mortgagor. The transfer is valid as between the parties without notice and all rights pass to the transferee. However, in order to require that payment under the loan is no longer made to the original lender, or to prevent set-off, or to enforce the mortgage, it is necessary to give notice to the mortgagor. In practice, for MBS issues, immediate notice at the time of transfer should generally not be needed, especially where the originator continues to service the loans, although cautious legal advisers may often recommend otherwise. In some countries uncertainty prevails. In a recent securitisation of mortgage loans in Ukraine,¹⁰ it was deemed necessary to notify the mortgagors of the assignment. Article 24 of the Ukrainian Mortgage Law provides that the mortgage creditor must notify the mortgagor of the assignment within five days, although the sanction for failing to do so is unclear.

Box 5**Mortgage certificates**

Mortgage certificates are sometimes issued in addition to the existing mortgage agreement (for example in Russia, the so-called *zakladnaya*, and in Ukraine) to facilitate the transfer of mortgage and to simplify enforcement procedures. They are instruments that entitle the holder to a lender's rights under a mortgage loan, including the right to start enforcement of the mortgage. Once it is shown in the land register that the mortgage is in certificated form, transfer or enforcement is not possible without production of the certificate. However, transfer does not require registration. There are usually separate loan and mortgage agreements, the certificate containing merely a summary.

On transfer, endorsement on the certificate and a separate transfer agreement are generally required. As with other legal contrivances that have been invented to support mortgage activity, an analysis of the reasons for using mortgage certificates shows that if the underlying issues are addressed, the reasons then fall away. Certainly avoiding the need for registration on transfer may be a significant advantage but this can be achieved more simply by removing any requirement to register mortgage transfers. Requiring a physical document evidencing the mortgage to be handed over on transfer is cumbersome and runs counter to current trends towards dematerialisation. There is also little logic in allowing mortgages evidenced by a mortgage certificate to be enforced more simply than those that are not. It is preferable to establish efficient procedures for enforcement and make them applicable to all mortgages.

c. Nature and effect of transfer of mortgage loans

In a classic MBS transaction it is important that, as a result of the transfer of the mortgage loans:

- a “true sale” is achieved whereby all rights in the mortgage loans pass from the originator to the SPV
- the mortgage loans are isolated from the originator: there is no prospect for the originator or any liquidator or administrator on the originator's insolvency to establish any continuing right in the mortgage loans or to “claw back” any interest in them. The risk of the sale of the loans being re-characterised, for instance as a secured loan or conditional sale, must be addressed. These issues are to a large extent untested in transition countries
- ancillary rights of the originator (such as rights in credit and property insurance or ancillary security)

are either included in the transfer automatically or can be included without onerous formality, so that the SPV is given in substance the same package of rights against the mortgagor to that previously enjoyed by the originator. For example, having to issue new insurance contracts naming the SPV as the new beneficiary under the existing insurance policies is clearly unduly onerous

- separate ongoing obligations of the originator to the mortgagor are not transferred, unless specifically agreed. If, for example, the originator has incurred obligations towards the mortgagor as part of the conduct of its business outside the contractual framework of the mortgage loan (for example under consumer protection legislation) those obligations properly belong with the originator and should not be transferred to an SPV that is acquiring financial assets.¹¹

Although it is important to establish a clear base position for the classic transaction, it is equally important to recognise the ever-growing trend of the market to create “hybrid” or “synthetic” structures, and to allow broad flexibility to parties to adapt the transaction by agreement. If, for example, the originator is to retain some continuing exposure to credit risk it should be possible to agree to this, and at the same time for parties to ascertain any consequences that this may have (for example on the accounting treatment of the transaction or the risk that the transaction will not be recognised as a true sale).

d. Registration of new mortgage creditor in the mortgage register

One of the biggest complications for MBS is the requirement to register the change of mortgage creditor in the land or mortgage register. In a classic covered bond issue the mortgage creditor remains the same and so there is no need for any entry in the mortgage register (but there may be registration in the “cover register” maintained by the issuer). But for MBS (and for some structured CB issues) the mortgage is transferred and in many countries a change in mortgage creditor either has to be registered or is registered as a matter of practice because of uncertainty as to the validity of unregistered transfers. This can entail extra costs, which may even be such as to discourage the issuing of MBS.¹² In some cases, devices such as mortgage certificates may be used to avoid the requirement but this is not without drawbacks (see Box 5).

The question that needs to be addressed is why registration of a change in mortgage creditor should be required at all. The issue is closely linked to the effects of mortgage registration discussed in Part III 3.5 c. On initial registration of a mortgage, the identity of the mortgage creditor is included in the information submitted for registration. This is easy to do, can be useful and causes no particular

problem. There is, however, no fundamental need that the identity of any person to whom the mortgage is subsequently transferred should appear in the register. Third parties are alerted that a mortgage is claimed over the property belonging to the mortgagor, and the time from which it has priority is established. Third parties have no specific need to know who is *currently* entitled to that claim. It is sufficient that any person seeking to exercise rights under the mortgage is able to demonstrate that he is entitled to do so.

The different practices that have developed to avoid registration show that there is no need to register the identity of persons to whom the mortgage creditor assigns his rights. If it is acceptable to create mortgage certificates that can be transferred without registration (see Box 5 on page 51), or to allow unregistered fiduciary transfers or equitable assignments, why should registration be required for other transfers?

There may be advantages in registering a change in mortgage creditor (for example to facilitate enforcement) and the possibility of making such registration can be left open as an option for the new creditor if and when this is judged useful. But if it is made an obligation any advantages are more than outweighed by the negative impact on mortgage securities transactions. A country that wants to establish a framework permitting the efficient use of mortgage securities should remove any requirement for mandatory registration of a change of mortgage creditor.

4.2 Pledge of mortgage loans and ancillary rights

In covered bond transactions the rights of bondholders to the mortgage loans in the cover pool will often be given by way of pledge. In MBS transactions the SPV will often give a pledge of the mortgage loans in favour of the noteholders.

Similar issues arise on pledge as on transfer. It should not be necessary to obtain consent from the mortgagor for

the pledge; notice to the mortgagor should not be needed as a condition of the validity of the pledge but merely to make it opposable, and it should not be necessary to enter the rights of the bondholders or noteholders as pledgee in the mortgage register. Registration of the pledge in a “pledge register” may be required but this should be a simple formality requiring a single registration covering all the mortgage loans.¹³ Because the cover pool for CBs is likely to be dynamic, it will be necessary in the pledge to describe the mortgage loans generally, including future loans, so as to avoid any requirement to renew the pledge registration each time the cover pool is amended. Much progress has been made in transition countries on pledge laws but still not all countries give this flexibility.

The ability to easily and effectively give security by way of pledge can greatly facilitate the contractual arrangements to mitigate risks in mortgage securities transactions. This concerns not only the pledge of the mortgage loans but also, for example, pledge over cash, bank accounts and accounts receivable. Countries that have a modern framework for secured transactions, enabling the grant of an enforceable, first-ranking pledge right that remains effective on the insolvency of the pledgor (be it the issuer or the originator), will have a great advantage.¹⁴

4.3 Payments and ongoing servicing of mortgage loans

An SPV acquires mortgage loans as a financial asset, without any intention to carry on mortgage business, and it will not be equipped to receive payments under, and to service, the mortgage loans it has acquired. It will normally rely on either the originator or another person to provide this service. The appointment of the originator to carry out administrative tasks on behalf of the SPV should not affect the “isolation” of the mortgage loans or give the originator any rights beyond those of any other agent carrying out such tasks. The SPV should also be

free to appoint any other person to collect payments and service the mortgage loans.

The obligation on the mortgagor under the mortgage loan is to make payment as instructed. Payment by a mortgagor to a servicer in accordance with instructions fulfils this obligation. No liability of the mortgagor should arise if the originator or the servicer fails to account to the SPV. From the standpoint of the SPV (and the noteholders) it is crucial that all payments made to the originator or other servicer are segregated. The money paid belongs to the SPV and is held by the servicer on its behalf. If the payments become mixed with other money held by the servicer there is a risk upon the insolvency of the servicer of competing claims from other creditors (the so-called commingling risk). Segregation can be achieved by various techniques, for example creating a special account into which payments are made, or setting up a trust or fiduciary arrangement.

4.4 Right of the SPV to enforce defaulting mortgage loans

The particular legal quality of a mortgage loan that makes it attractive for securitisation transactions is the mortgage (security) that is attached to it. When a mortgage loan defaults, the SPV – as the new mortgage creditor replacing the originator – should have the right to enforce the mortgage. It is essential that mortgage enforcement is quick and efficient (see Part III 4 and 5). The formalities for enforcement should also not be made more complex, for example by a requirement to join the originator as a party. Typically the task of recovering defaulting mortgage loans, and if necessary enforcing, will be entrusted to the servicer and it should be possible for the servicer (or other person appointed by the SPV) to exercise enforcement rights on behalf of the SPV. Similarly an SPV or its agent should be able to enforce rights against insurance proceeds and other security rights connected to a defaulting mortgage loan.

4.5 Confidentiality of information

A mortgage securities transaction requires information about the mortgage loans to be made available to persons who are not party to the loans. Consumer protection or banking secrecy rules should not (subject to appropriate protections) prevent information on mortgage loans being provided to:

- an SPV in the context of a transfer of a mortgage pool
- investors in the context of the issue of CBs or MBS
- a third party appointed to service loans
- a person entitled to enforce the loan.

A balance has to be achieved that affords adequate protection to mortgage borrowers while avoiding unnecessary restrictions that may hamper mortgage securities transactions. The Mortgage Funding Expert Group recommended:¹⁵

“1. that personal data be permitted to be transferred between originators and third parties, including lenders and servicers that have a legitimate professional reason to review the data. The receiver must, however, treat the information confidentially.

2. that personal data, excluding borrower’s name or address, be permitted to be disclosed to investors for the purposes of investment decisions.”

Endnotes

- 1 Covered bonds are debt securities issued by credit institutions and covered by certain types of assets – usually mortgage loans but it can also be public sector debt or ship loans. This work only deals with bonds covered by mortgage loans (sometimes referred to as mortgage bonds).
- 2 As *The Economist* put it: “The art of securitisation, as it is called, adds liquidity to the market and allows risk to be parcelled out to those most eager to bear it. Over the past few years, it has also freed up cash for more lending and earned banks pots of money.” (17 February 2007, p. 80)
- 3 As in the UK’s HBOS structured covered bond issue in 2003, and the issue of covered bonds by Washington Mutual Bank in September 2006 in the United States.
- 4 See European Mortgage Federation (2007) *Study on the Efficiency of the Mortgage Collateral in the European Union*: “Mortgage lenders should be free to choose the most appropriate funding strategy for their business and have equal access to mortgage funding markets and investors irrespective of their location. Any regulation should not favour one form of funding above another, since each funding instrument has its own advantages and disadvantages based on its particular product characteristics.”
- 5 See the bibliography in Annex 5 and in particular L. Chiquier, O. Hassler and M. Lea (2004) *Mortgage Securities in Emerging Markets*, World Bank Financial Sector Operations and Policy Department, Policy Research Working Paper 3370.
- 6 See Chiquier et al, page 33.
- 7 See the EBRD List of Minimum Standards of Mortgage Loans and Mortgage Manual, July 2007, for standards and best practices.
- 8 European Securitisation Forum (2002), *A Framework for European Securitisation*, London.
- 9 It is assumed that mortgagor and debtor are the same person, but this may not always be the case.
- 10 In February 2007 PrivatBank, the largest Ukrainian bank, issued MBS for US\$ 180 million.
- 11 See European Securitisation Forum (2002), *A Framework for European Securitisation*, goal 1.2: “To have laws and regulations that do not transfer or impose liability which is properly borne by the originator onto an assignee or financier of assets.”
- 12 This is reported to have been the case, for example, in Poland.
- 13 See EBRD Guiding Principles for the Development of a Charge Register at www.ebrd.com/country/sector/law/st/core/pubsec.pdf.
- 14 For further details on secured transactions regime in transition economies see “Regional Survey” at www.ebrd.com/st.
- 15 The Mortgage Funding Expert Group was created by the European Commission as an ad hoc expert working group in 2006. For more details see http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm#mfeg.

Part VI: Conclusions

Mortgage markets may appear hugely complex but the legal basics for mortgage are (i) in all models fairly similar and (ii) quite simple.

Providing the right legal framework – or to use the concept underpinning the whole of this work, an efficient legal framework – is very much within the reach of transition countries. Commitment to reform has already paid off: the Mortgage Regional Survey shows that a number of countries already go a long way towards offering efficient systems, which over the coming years may compare favourably with systems in operation in western markets.

We summarise below some of the more important findings and conclusions, distinguishing between those that are broadly relevant across the field of mortgage law and matters of more specific application.

Broad conclusions and recommendations

Essential requirements

Giving security by way of mortgage is a relatively simple and standard operation that is frequently carried out between willing parties to facilitate economic activity, mostly in the private sector. The legal framework for mortgage should be designed to maximise economic benefit. The legal efficiency criteria (simplicity, speed, low cost, certainty and fit-to-context – see Part II 2 and Chart 3 on page 9) can be used to assess whether it achieves this. The basic requirements for a mortgage law are encapsulated in the core principles (see Box 1 on page 11 and Annex 1).

Integral part of secured transactions law

The regime for mortgage should be similar to that for security over any other asset. Some special rules specific to the particular nature of real property are needed but having different rules apply to common issues (such as the description of the secured debt and the method of enforcement) depending on whether the charged asset is movable or immovable does not make sense. The inefficiency of such an approach becomes all the more apparent in the context of mortgage securities, when security is given both in the form of mortgage and of pledge.

Consensual nature of mortgage

Modern markets continue to create many variations on the way mortgage finance can be structured. Notwithstanding the essentially simple and standard nature of a mortgage the parties should be allowed to shape all aspects of their agreement according to the circumstances of their transaction.

Compatible with mortgage securities

Mortgage markets depend on the availability of finance, and for that mortgage securities are increasingly important. Mortgage securities are not feasible unless there exists a sound and compatible regime for mortgage. Transition countries that are reforming their mortgage law have a unique opportunity to ensure that it does exist.

Precondition for mortgage reform

The success of any mortgage reform will largely depend on the understanding by all parties involved of the economic role of mortgage and the way secured credit markets work, and a determination to remove unnecessary mystique, formality and complexity. Without that understanding there is little chance that the law and the legal institutions that implement it will operate in a way that realises the full potential economic benefits of the reform.

Specific issues and recommendations

Secured debt or claim

By restricting the form of debt secured by mortgage, especially by imposing a specific definition of the debt at the time the mortgage is created, the law may negatively influence the development of mortgage lending products, such as loans with variable payments or lines of credit secured by mortgage, and so on. These restrictions arise principally from legal doctrine and tradition. The resistance to making the necessary (and sometimes difficult) changes to the law generally fall away when the economic role of security is well understood.

Constructions

A mortgage over land should include constructions on it, including new constructions after the date of the mortgage. Treating constructions, for purposes of ownership and registration, as separate from the land plot on which they are built creates problems for establishing adequate security over the property, particularly in the case of new construction projects.

Transparency of information

For a mortgage to be created and the rights of the mortgage creditor to be subsequently protected, information on title and mortgages needs to be available. The internet provides the most efficient way of giving immediate public access to that information and it is already used in a number of countries. This should be strongly encouraged.

Registration of mortgages

Registration of mortgage is needed to publicise the existence (or claimed existence) of a mortgage and to establish the precise time from which it would have priority. A requirement that registration also guarantees the validity of the mortgage (in the same way as for a transfer of land) is unnecessary and inefficient. With a notification system immediate registration of mortgages at minimal cost becomes a real possibility.

Flexibility in enforcement methods

The principal aim of enforcement is to realise the mortgaged property promptly at market value. Recent reports indicate that many transition countries are relatively successful in this respect, but that may be due as much to favourable market conditions as to the strength of their systems. Allowing the mortgage creditor choice as to the manner of realisation, and control over the realisation process (linked to a duty of diligent execution), is likely to be conducive to improving and sustaining enforcement results.

Efficient enforcement process

Mortgagor and mortgage creditor should share a similar interest that the mortgaged property be realised at the best price. The prerequisites to enforcement and the process by which it is achieved from the formalities of commencement to the distribution of proceeds should be legally efficient. If they are not, delay and complexity are likely to increase the costs, therefore reducing the net proceeds, and inefficiency may give the mortgagor opportunities to obstruct the process.

Role of the court in enforcement

Enforcement represents the execution of a contractual agreement and should primarily be led by the parties. The principal role of the court is to resolve disputes and uphold the parties' rights, if and when requested to do so. The court must be prepared and equipped to react promptly and order appropriate remedies.

Transfer of mortgage

Mortgage securities transactions require the transfer or pledge of mortgage loans and it should be possible to achieve this efficiently without onerous requirements as to documentation, notice, consent or registration. It is preferable that this is the case for all mortgage loans, not just those that are structured in a particular way (for example, as mortgage certificates) when transfer or pledge is envisaged. Transition countries could achieve more efficient systems than those operating in many western jurisdictions.

Registration of the mortgage creditor

The complication that regularly hampers the transfer of mortgage loans is the requirement to register the change in mortgage creditor in the mortgage register. There is no fundamental need to publicise that change on the register. Any advantage that may arise from registration is more than outweighed by the inefficiency that this creates for mortgage securities transactions.

In spite of recent concerns affecting mortgage finance markets it is evident that there is enormous growth potential in the transition countries. The economic advantage resulting from that growth will be all the greater where the legal framework for mortgage has been made legally efficient.

Annex 1: EBRD Core Principles for a Mortgage Law

The principles are drawn on the assumption that the role of a mortgage law is economic. It is not needed as part of the essential legal infrastructure of a country: its only use is to provide the legal framework which enables a market for mortgage credit to operate.

The principles do not seek to impose any particular solution on a country – there may be many ways of arriving at a particular result – but they do seek to indicate the result that should be achieved. As with any set of general principles of this nature they must be read within the context of the law and practice of any particular country and they do not aim to be absolute; exceptions inevitably have to be made.

Principle No 1

A mortgage should reduce the risk of giving credit, leading to an increased availability of credit on improved terms.

The first principle is overriding: *If the legal framework for mortgage does not lead to a reduction in the risk of giving credit and an increased availability of credit on improved terms, then there is no point in the law providing for mortgage at all.* This goes to the basic assumption made by EBRD on all its work on mortgage law reform. Every element of the legal framework should be analysed against this basic principle.

Principle No 2

The law should enable the quick, cheap and simple creation of a proprietary security right without depriving the person giving the mortgage of the use of his property.

The second principle relates specifically to creation. It is more prosaic than the first but it permeates many aspects of the law on mortgage. The trio of simplicity, speed and inexpensiveness is fundamental and ties in directly with the concept of legal efficiency: formal requirements should be kept simple and the costs low. Every cost, irrespective of who bears it, that is involved in the creation of mortgage detracts from the benefits that mortgage provides. Any delays or complexities translate into cost.

Principle No 3

If the secured debt is not paid the mortgage creditor should be able to have the mortgaged property realised and to have the proceeds applied towards satisfaction of his claim prior to other creditors.

This principle is also at the core of the mortgage's economic purpose. The exact nature of the proprietary right that arises when security is granted has to be defined in the context of the relevant legal reform, but if it is to be effective it must link to the creditor's claim the remedy of recovering from the property given as security.

The mortgage creditor should maintain a prior claim on the proceeds of realisation of the property (subject to the right of any pre-existing, prior-ranking creditor).

Principle No 4

Enforcement procedures should enable prompt realisation at market value of the mortgaged property.

What gives a mortgage its value, and therefore enables borrower and lender alike to derive benefit from it, is the confidence that it can be used, if necessary, to repay the creditor's claim. The greater the doubts of the creditor as to his ability to enforce or the conditions under which he would do so, the less will be the influence of the mortgage when he decides whether to lend and on what terms.

When a creditor comes to enforce he needs to be able to realise the property rapidly. Delays in realisation are likely to be a source of uncertainty and cost. The property should be realised at the same value as on any other sale in the market. Any surplus proceeds beyond those needed for satisfying the secured claim returns to the mortgagor, and there is no justification for penalising him by a realisation at below market value.

Principle No 5

The mortgage should continue to be effective and enforceable after the bankruptcy or insolvency of the person who has given it.

The position against which the creditor most wants protection is the bankruptcy or insolvency of the debtor. Any reduction of rights or dilution of priority upon bankruptcy or insolvency will reduce the value of security. The validity of the mortgage should not be affected by insolvency (with the exception of fraudulent or preferential transactions or those carried out in the suspect period, but the same rules should apply as for other pre-insolvency transactions). Any rules permitting a moratorium or reorganisation of the debtor's assets should aim to strike a fair balance between the interests of the mortgage creditor and other parties.

Principle No 6

The costs of taking, maintaining and enforcing a mortgage should be low.

The mortgage creditor will usually ensure that all costs connected with the mortgage are passed on to the debtor. High costs of mortgage creation (mortgage agreement, registration and so on) will increase the cost of borrowing and thus diminish the efficiency of the secured credit market. Enforcement costs will reduce the proceeds on realisation and will influence a mortgage lender's assessment of the value of his security. Simple and fast procedures for creating and enforcing mortgage will help to reduce costs.

Principle No 7

Mortgage should be available (a) over all types of immovable assets (b) to secure all types of debts and (c) between all types of person.

This principle covers a multitude of issues that may arise from legal tradition, the way the law is applied and the needs of commercial reality. A mortgage should be available over all types of immovable assets. There is little justification to allow mortgage over some properties and not over others. Similarly a mortgage should be capable of securing all types of debts, present and future, specifically or generally defined, that can be expressed as a money amount. Any physical or legal person (whether in the public or private sector) who is permitted by law to transfer property should be able to grant security over it to any other person.

Principle No 8

There should be an effective means of publicising the existence of a mortgage.

Publicity is needed to ensure that any person can be alerted to the existence of the mortgage. When taking a mortgage the creditor will want to discover whether any pre-existing mortgages have a prior claim. And once his mortgage is created he will want to be sure that anyone subsequently claiming a right in the property is made aware of his claim. Without a reliable system for publicity a creditor is unlikely to have sufficient certainty in his rights in the mortgaged property.

Principle No 9

The law should establish rules governing competing rights of persons holding mortgages and other persons claiming rights in the mortgaged property.

Certainty in his rights over the mortgaged property is key to the mortgage creditor. He needs to know what rights of other persons may take precedence over his right of mortgage, for example, other mortgages, tax liens, rights of occupation or rights of spouses, in order to be able to assess and value his security. The political or social justification for any right of a third party which dilutes or compromises the ability of the mortgage creditor to recover his claim out of the mortgaged property should be balanced against the loss of credit opportunity which may result.

Principle No 10

As far as possible the parties should be able to adapt a mortgage to the needs of their particular transaction.

The law is there to facilitate the operation of the mortgage market and to ensure that necessary protections are in place to prevent the debtor, other creditors or third parties being unfairly prejudiced by the existence of the mortgage. Parties should be allowed wide contractual flexibility. There are few cases which justify the law, or the institutions that implement it, creating rules or barriers which limit the manner in which parties can structure their transaction.

Annex 2: Mortgage Regional Survey –

The survey is best understood if read in conjunction with the EBRD Core Principles for a Mortgage Law (see Annex 1), which specify the basic criteria for modern mortgage law, and the explanatory notes (see Annex 3), which describe the methodological approach to the survey.

	Bulgaria	Croatia	Czech Republic	Estonia	Georgia	Hungary	
1 Creation of the mortgage							
1.1 Can existing title to property be established with sufficient certainty?	xx †	✓✓ †	✓✓✓	✓✓✓	✓✓✓	✓✓✓	
1.2 Is the manner of creation of mortgage clearly established?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	
1.3 Is creation of mortgage simple?	xx †	xx †	✓✓✓ †	✓✓✓	✓✓✓	✓✓ †	
1.4 Is creation of mortgage rapid?	✓✓	✓✓	xx †	xx †	✓✓	xx †	
1.5 Is creation of mortgage inexpensive?	✓✓	✓✓✓	✓✓✓	✓✓	✓✓	xx †	
2 Commercial effectiveness							
2.1 Can a mortgage be granted by any person?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	
2.2 Can any person take a mortgage?	✓✓✓	✓✓✓ †	✓✓✓	✓✓✓	✓✓✓	✓✓✓	
2.3 Can the mortgage secure any type of debt?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	
2.4 Can the secured debt be in any form?	xx †	✓✓ †	xx †	✓✓✓	✓✓ †	✓✓✓	
2.5 Can the mortgage cover all types of immovable asset?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	
2.6 Does the mortgaged property include subsequent constructions and additions?	✓✓ †	✓✓✓	xx †	✓✓✓	✓✓✓	✓✓✓	
2.7 Are subsequent mortgages permitted over same property?	✓✓✓	✓✓✓ †	✓✓✓ †	✓✓✓ †	✓✓✓	✓✓✓	
3 Effect of the security right on third parties							
3.1 Is the mortgage creditor protected from subsequent claims which may adversely affect the mortgagor's title to the property?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	
3.2 Does mortgage give priority in mortgaged property?	✓✓✓	✓✓ †	✓✓✓	✓✓✓	✓✓✓	✓✓ †	
3.3 Does the mortgage creditor have priority in bankruptcy?	✓✓✓	✓✓ †	✓✓✓ †	✓✓✓	✓✓ †	✓✓✓	
3.4 Can a third party determine whether property is mortgaged?	✓✓ †	✓✓✓	✓✓ †	✓✓✓	✓✓✓	✓✓✓	
4 Enforcement of the mortgage							
4.1 Is the manner of enforcement of mortgage clearly established?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	
4.2 Is enforcement of mortgage rapid?	✓✓	✓✓	xx	✓✓✓	xxx	✓✓✓	
4.3 Is enforcement of mortgage inexpensive?	xx	✓✓✓	xx	xx	xxx	xx	
4.4 Is realisation likely to be at market value?	xx	xx	✓✓	✓✓	xx	xx	
4.5 Is enforcement procedure simple?	✓✓✓	✓✓ †	✓✓✓	✓✓✓	xx †	✓✓ †	
4.6 Can the mortgage creditor decide on the way the sale will be conducted?	xxx	xxx	✓✓ †	xxx	xxx	✓✓✓	
4.7 Can the mortgage creditor exercise control over the realisation process?	xx †	xxx	✓✓ †	xxx	xxx	✓✓✓	
4.8 Is the mortgage creditor protected against mortgagor obstruction?	✓✓ †	✓✓ †	✓✓ †	✓✓✓	xxx †	✓✓ †	
4.9 Does commencement of enforcement have to be publicised?	xxx	✓✓✓	xx †	xxx	xxx	xx †	
4.10 Is purchaser in enforcement procedure protected?	✓✓✓	✓✓✓	✓✓ †	✓✓✓	✓✓✓	✓✓ †	

Notes to the composite table on the previous page

Bulgaria

- 1.1 Registration is currently being converted from a personal to a property-based system and from a paper-based to an electronic system. There are also unregistered restitution claims outstanding.
- 1.3 There are title and searching problems, onerous registration formalities and problems in obtaining required tax certificates. Re-registration is required after 10 years.
- 2.4 Specific description of the secured debt is required and there is uncertainty over securing credit facilities and fluctuating debt.
- 2.6 There is some uncertainty and in practice future constructions are often specifically referred to in the mortgage agreement.
- 3.4 There can be some uncertainty due to the person-based records.
- 4.7 The mortgage creditor can appoint a private bailiff to conduct the sale.
- 4.8 In the case of residential property, the mortgagor can apply to court to suspend the procedure or reschedule the payments.

Croatia

- 1.1 Land registry has greatly improved in the last few years but remains incomplete in some parts of the country.
- 1.3 Additional security (for example, personal guarantee, seizure on salary) is usually requested, which makes the transaction more complex.
- 2.2 For a fiduciary transfer a foreigner would need governmental approval.
- 2.4 There is some uncertainty in practice.
- 2.7 For fiduciary transfer it is not possible. A clause prohibiting further mortgages is void.
- 3.2 There is some uncertainty on the priority of tax claims.
- 3.3 There is some uncertainty on the priority of tax claims.
- 4.5 The procedure for public auction is court-led and rather formalistic.
- 4.8 The mortgagor could cause severe delays by submitting multiple objections.

Czech Republic

- 1.3 Mortgage agreement must be presented in several copies (depending on number of parties involved, plus two).
- 1.4 Registration of mortgages takes between two weeks and six months. However, banks often disburse mortgage credit following the application for registration.
- 2.4 A mortgage can only secure, up to an agreed amount, a debt of a specific kind during a defined period.
- 2.6 Additions to land encumbered by a mortgage would not automatically be included in a mortgage of the land.
- 2.7 A clause prohibiting further mortgages is void.
- 3.3 On the basis of the new Law on Insolvency that comes into force early 2008, a mortgage creditor will have full priority over the mortgaged property.
- 3.4 There may be a time gap between the moment tax liens become effective and their registration.
- 4.6 There is a choice between court-led sale and a privately led auction.
- 4.7 Privately led auction is carried out by a private auctioneer and gives the creditor limited control subject to complying with detailed rules under auction law.
- 4.8 The public auction is open to challenge in which case its continuation becomes subject to court approval.

- 4.9 Enforcement is only registered if it is carried out through court procedure and then only after a court order is obtained.
- 4.10 The law provides for a three-month period within which an auction can be challenged but allows a limited list of reasons justifying such a challenge.

Estonia

- 1.4 Registration takes about one month but mortgage lenders commonly disburse loans after the application for registration has been submitted. The creation process is also delayed by time taken to obtain necessary notarial intervention.
- 2.7 A clause prohibiting further mortgages is void.

Georgia

- 2.4 In principle, it is possible to secure generally described and fluctuating debt but practice is not well established.
- 3.3 Priority only applies to 75 per cent of the secured debt.
- 4.5 Court practices can cause uncertainty.
- 4.8 The mortgagor and dependants are legally allowed to remain in the property as tenants. The mortgagor could also apply for suspension of the public auction for a period of up to six months.

Hungary

- 1.3 The formalities of land offices and inconsistencies of practice can complicate the registration process.
- 1.4 Registration may take well in excess of the prescribed 30-day maximum, but there is a system of noting pending registration.
- 1.5 Costs are relatively high for lower amounts of debt. It has been assumed that a notary is used.
- 3.2 Claims (child support, alimony, wages of employees and other employment-related benefits) may have priority.
- 4.5 Some uncertainties exist in relation to out-of-court procedures.
- 4.8 The mortgagor can delay the enforcement procedure.
- 4.9 There is a requirement to register the commencement of court-led enforcement but there appears to be no sanction for failure to do so. Enforcement through a private sale is not publicised.
- 4.10 On out-of-court enforcement the purchaser will not be protected against third-party claims unless the sale is conducted by a professional auctioneer or dealer.

Kazakhstan

- 1.1 The legal cadastre (run by the Ministry of Justice) and land cadastre (run by the Land Committee) contain many discrepancies on title.
- 1.3 The registration process can be complex and different practices are reported between different registration offices.
- 1.4 Mortgage registration takes about three weeks. However, banks disburse mortgage credit after the application for registration has been submitted.
- 2.4 Requirements for specification of secured debt limit the possibility to describe debt generally.
- 2.6 The legislation does not provide for automatic inclusion in the mortgage of future buildings erected on the mortgaged land.
- 2.7 Prohibitions on further mortgage may be registered in the real estate register.
- 3.3 Some claims (damage to health, claims for wages and alimony) have priority.

- 3.4 Some registration offices are reported to require authorisation from the mortgagor for obtaining information from the register.
- 4.5 The legislation does not currently provide for the method for holding tenders in out-of-court proceedings. This causes uncertainty and fear that the tender may be declared invalid.
- 4.6 There is a choice between court-led and out-of-court enforcement (if so provided in the mortgage agreement). Sale is at public auction in both cases.
- 4.7 The mortgage creditor may appoint the executor who carries out the auction in out-of-court enforcement.
- 4.8 In the case of property not used for business activities and agricultural land the mortgagor can apply to the court for enforcement to be postponed for one year.
- 4.10 The mortgagor may appeal within three months after the auction.

Kyrgyz Republic

- 1.1 Titles are not always accurately registered and can be subject to challenge.
- 1.3 Registration requires presentation of many documents.
- 2.4 There is some doubt whether a mortgage can secure a generally described debt.
- 2.5 Restrictions apply on agricultural land.
- 2.6 Parties could agree so but it is uncertain how this clause would be upheld in practice.
- 3.4 Only limited information is publicly available.
- 4.1 There is little practice.
- 4.2 The realisation procedure should be quick but practical experience is limited.
- 4.4 Practical experience is limited.
- 4.5 Detailed procedures are provided in the law but there is little experience in practice.
- 4.6 The law gives the creditor choice but there is uncertainty if this is always available in practice.
- 4.7 The law gives the creditor control but there is uncertainty if this is always available in practice.
- 4.8 The mortgagor can challenge the private sale. Evicting occupants from the property is reported to be difficult.
- 4.10 Purchaser's title can be challenged on specific grounds.

Latvia

- 2.4 Although the secured amount may be in a foreign currency, the amount secured is the Latvian lat amount that is shown in the land register.

Lithuania

- 1.3 The form of the mortgage agreement is strictly defined and registration requires various documents and information on the value of the mortgaged property.
- 2.3 Consumer loans cannot be secured by a mortgage.
- 2.4 If the mortgage does not secure a specific debt, the maximum amount and use of monies have to be stated and the mortgage validity is limited to five years.
- 3.1 There are still unresolved restitution claims, and these are not registered against the land.

Poland

- 1.1 There is still a significant amount of land for which checking title may be difficult.
- 1.3 Registration procedures are formalistic (although they have been simplified for banks' mortgages) and practice is not consistent. It is often necessary to create more than one mortgage because of technical distinctions between different debts.
- 1.4 Banks commonly disburse loans before registration is completed, based on confirmed registration application and/or additional collateral.
- 2.4 A generally defined debt or a fluctuating pool cannot be secured. A future debt can only be secured if defined specifically. There is a complex distinction between "capped" and "fixed amount" mortgages.
- 2.7 A clause prohibiting further mortgages is void.
- 3.1 There is still some limited risk of a restitution claim.
- 3.2 Some claims (alimony, last three months' employee wages and invalidity pensions) take priority over the mortgage creditor's claim.
- 3.4 Obtaining excerpt may be limited to interested persons.
- 4.5 The procedures are formalistic and the operation of the bailiff system is reported to be inefficient.
- 4.9 The bailiff is required to register commencement of enforcement in the land register, but in practice there may be delay before registration is completed.

Romania

- 1.1 A significant amount of property is not registered. Even where a property is registered it may be necessary to check previous transfer deeds since entry into the register does not guarantee title.
- 1.3 It is simple unless there are problems establishing title.
- 1.4 It is quick unless there are problems establishing title.
- 1.5 Costs are relatively high for lower amounts of debt.
- 2.2 There are restrictions on who can take mortgages under the Mortgage Lending Law.
- 2.3 There are restrictions on what debts can be secured by a mortgage under the Mortgage Lending Law.
- 2.4 There are conflicting views on the way the secured debt should be described in the register, especially its amount.
- 2.6 Additional procedures are necessary to include future additions. There is a practice of registration of mortgage over future constructions in the Electronic Archive for Security Interests in Personal Property to cover subsequent improvements.
- 2.7 Prohibitions on further mortgage may be registered in the land register.
- 3.1 There are a number of restitution claims which are unresolved.
- 4.5 Court procedures are necessary both to confirm executory title and authorise realisation. Greater court involvement is necessary if the creditor is not an authorised bank.
- 4.7 Banks can use their own enforcement officer but the mandatory public auction procedure has to be followed.
- 4.8 The mortgagor has scope to delay enforcement.

Russia

- 1.1 Rights acquired since 1998 are registered but there can be uncertainty establishing title acquired before then.
- 1.3 There are a number of documents required for registration that, along with inconsistencies in practice of registration offices, make registration formalistic and complex.
- 2.4 Specific identification of secured debt is generally required which makes it difficult to secure future, fluctuating or generally described debt.
- 2.7 Prohibitions on further mortgage may be registered in the land register.
- 3.2 Imprecise wording of the Enforcement Law leaves doubt as to whether the secured claim would not be superseded by other claims, such as tax claims.
- 3.3 Claims for personal injury and employees' claims take precedence if arisen before the mortgage right. There is uncertainty as to whether the secured claim would not be superseded by other claims, such as tax claims.
- 4.1 The process is clear but courts are reported to have discretionary power to decide whether or not enforcement is "proportionate".
- 4.5 Obtaining a court decision to enforce a mortgage is complex and the outcome of the court-led sale is uncertain.
- 4.8 Mortgagors often successfully apply for postponement of the enforcement for a period of up to one year.
- 4.9 Enforcement is registered after the court order is obtained.

Serbia

- 1.1 There are currently three separate and non-consolidated regimes for the registration of immovable property. Unification of these systems is ongoing. Many properties are not yet registered at all.
- 1.3 The process can be complex if the property is under construction or unregistered.
- 1.4 Registration can take some time to complete but mortgage creditors are reported to disburse after the application for registration has been submitted.
- 2.4 Requirements for specific description of debt would make it difficult to secure fluctuating and generally described debt.
- 2.6 This seems possible but it would be preferable to register a mortgage over the building in construction.
- 2.7 A clause prohibiting further mortgages is void.
- 3.1 There is a risk of unresolved restitution claims.
- 4.1 There is little practice.
- 4.2 The new out-of-court enforcement procedure has not yet been put to the test.
- 4.4 The new out-of-court enforcement procedure has not yet been put to the test.
- 4.5 There is uncertainty as to how the courts may interpret the out-of-court enforcement rules.
- 4.8 The law is clear but practice is still limited.

Slovak Republic

- 1.3 The process for applying for registration is simple but mortgage agreement must be presented in several copies (depending on number of parties involved, plus two). There are some inconsistencies of practice between different cadastre offices.
- 1.4 Registration can take one month or more. Expedited registration (normally within 15 days) is available at a higher fee.
- 1.5 Costs are relatively high for lower amounts of debt. It has been assumed that expedited registration is used.
- 2.6 Additions to land encumbered by a mortgage would not automatically be included in a mortgage of the land.
- 4.8 Debtor obstruction is reported to be a problem, in particular with regards to occupant eviction and access to premises for expert evaluation.

Slovenia

- 1.4 Registration can take more than one month. A note is made in the register of pending applications.
- 2.4 There are restrictions on the transfer of "maximum amount" mortgages.
- 2.7 A clause prohibiting further mortgages is void.
- 4.9 Mortgage enforcement is publicised only after the court order is obtained.

Ukraine

- 1.1 The immovable property registration system has not yet been unified, and title cannot always be established with certainty.
- 2.5 There are limitations on mortgages over agricultural land.
- 2.7 Consent of the prior mortgage creditor is necessary. Parties are likely to register a prohibition to sell the property, which would be opposable to all.
- 3.1 Minors can acquire the right to stay in the premises. See question 4.8.
- 3.2 There is some uncertainty as to whether tax liens would not take precedence.
- 4.4 There are doubts that realisation would remain close to market value in less buoyant conditions.
- 4.8 Remedies of the mortgage creditor against obstruction are limited. Laws protecting minors place barriers on the simple and fast eviction of occupants.
- 4.10 The public auction can be appealed against within three months.

Annex 3: Mortgage Regional Survey – explanatory notes

The questions in the survey are designed to be straightforward and easily understood. The following notes provide background information on how the scope of the questions has been defined in practice and on the methodology used for deciding the grading.

For the legal efficiency indicator charts and table (see Charts 7-12 and Table 5), countries were rated as follows:

Very efficient – Unqualified yes (✓✓✓) on all relevant questions
Efficient – Unqualified or qualified yes (✓✓✓ or ✓✓) on all relevant questions
Some inefficiency – Negative rating (✗✗ or ✗✗✗) on one relevant question
Inefficient – Negative rating (✗✗ or ✗✗✗) on two or more relevant questions
Unclear – Unclear rating (?) on one or more relevant questions.

1 Creation of mortgage

This section relates solely to mortgages created by agreement between the parties and excludes any consideration of the creation of mortgages (or equivalent) by operation of law or by judicial or administrative order. For the purposes of the survey a mortgage is treated as created when it is opposable against third parties. “Creation of mortgage” covers the whole process necessary to constitute a mortgage, including any registration or publicity that may be required to make it opposable to third parties.

1.1 Can existing title to property be established with sufficient certainty?

The effectiveness of a registration system for establishing title depends on whether all title claims are apparent from a search of the register and can be relied on. Title can also be established through title deeds.

1.2 Is the manner of creation of mortgage clearly established?

This question takes into account (i) whether the rules are clear; (ii) whether there is established practice; and (iii) the extent to which there are uncertainties in practice.

1.3 Is creation of mortgage simple?

The most frequent problems relate to inefficient and/or unnecessary administrative requirements, especially for formalities of agreement and for registration (for example, for documents and/or information that has to be produced, for the formal manner in which they have to be presented and the method and extent of checking required). Where creating a mortgage is complex because of ancillary requirements – for example, obtaining a mortgagor’s tax certificates – this is taken into account.

1.4 Is creation of mortgage rapid?

The grade given is based on the time likely to be taken to complete all necessary steps for a simple mortgage transaction (checking title, signing agreement, registering):

✓✓✓	1 week or less
✓✓	1-2 weeks
✗✗	2-4 weeks
✗✗✗	More than 4 weeks

When registration takes over two weeks but there is a notation system alerting third parties of pending registration, and as a result banks commonly advance credit prior to the completion of registration, these circumstances are taken into account.

1.5 Is creation of mortgage inexpensive?

The question looks at direct costs that specifically apply to the legal process of creating a mortgage over a property, and that in practice cannot be avoided. These include title search fees, registration fees, taxes (including VAT), but exclude any costs that would apply to the transfer of title (which would apply in the case where the mortgage loan is used to purchase a property). In countries where the services of a notary are mandatory or in practice systematically sought, notary fees have been included. Preferential or subsidised rates have been ignored. When costs would vary depending on whether individuals or legal entities were involved, it has been assumed that the mortgage was given by an individual.

Costs that do not arise from the legal process (such as property evaluation or bank fees) and costs that are linked to the complexity of the creation procedure (for example legal advice) are outside the scope of this question.

Costs have been assessed on three different loan values (see the table below). The selected debt values are designed to reflect amounts of credit typically provided in the transition countries.

	Costs on secured debt of €20,000	Costs on secured debt of €50,000	Cost on secured debt of €200,000
✓✓✓	Up to 0.75%	Up to 0.5%	Up to 0.25%
✓✓	Between 0.75 and 1%	Between 0.5 and 0.75%	Between 0.25 and 0.5%
✓	Between 1 and 2%	Between 0.75 and 1%	Between 0.5 and 0.75%
✗✗✗	Over 2%	Over 1%	Over 0.75%

2 Commercial effectiveness

The questions in this section are designed to assess the extent to which the legal framework and the way it is applied in practice are adapted to the needs of commercial transactions in modern market economies.

2.1 Can a mortgage be granted by any person?

It is assumed in the grading that the person has a right over the property that is mortgaged (he cannot create a mortgage over another person's property) and has legal authority or capacity to grant a mortgage (for example, he is not a minor or mentally incapacitated).

In many jurisdictions there are restrictions on the right to mortgage state-owned property.

2.2 Can any person take a mortgage?

It is assumed that the person has legal authority or capacity to take a mortgage.

Special rules that may apply to authorised mortgage lenders are not taken into account. Restrictions on foreign persons owning property are not taken into account unless the mortgage or its enforcement requires the mortgage creditor to become owner.

2.3 Can the mortgage secure any type of debt?

The question assumes that the debt is defined or definable in monetary terms. It does not relate to restrictions on the person who can be mortgagor or mortgage creditor that are noted under questions 1 and 2 in this table. Restrictions on consumer lending are not taken into account.

2.4 Can the secured debt be in any form?

This question covers four issues:

- Can the secured debt be defined generally? Where there is an obligation of specific identification of the secured debt which precludes or limits the ability to use a general description, this is noted and reflected in the grade.
- Can a future debt be secured?
- Can the debt be in a foreign currency? A requirement to state the equivalent in local currency will lead to a downgrade if this may limit the ability of the creditor to recover the full foreign currency amount on enforcement. On the contrary, where the register or the mortgage document has to specify the amount in local currency solely for information purposes, the grade of ✓✓✓ is given. Exchange control restrictions are not taken into account. The treatment of foreign currency claims under bankruptcy/insolvency procedures is outside the scope of this survey.
- Can a fluctuating pool of debt be secured? An obligation to specify the secured debt, or a restriction on future debts, which precludes or limits the ability to secure a fluctuating pool of debt (for example, amounts borrowed on overdraft or a revolving credit facility where the amount outstanding may decrease or increase from day to day), is noted and reflected in the grade.

2.5 Can the mortgage cover all types of immovable assets?

When a prohibition applies to property of particular historic, artistic or national security significance, this does not lead to a downgrade.

2.6 Does the mortgaged property include subsequent constructions and additions?

This question covers mainly the automatic inclusion within the mortgaged property of subsequent constructions on and additions to the mortgaged property.

The question does not extend to the ability to grant a mortgage over a separate future property (for example an apartment not yet built), but where the practice exists it may be noted.

2.7 Are subsequent mortgages permitted over same property?

Where there is a practice of registering the agreement of the mortgagor not to create further mortgages (negative pledge) in order to make it effective against third parties, a downgrade is given. The invalidity of negative pledge clauses is also noted for information. Banking or other regulations requiring banks to take a first-ranking mortgage (for example in order to qualify for the issue of mortgage securities) do not result in a downgrade.

3 Effect of the security right on third parties

3.1 Is the mortgage creditor protected from subsequent claims which may adversely affect the mortgagor's title to the property?

The question covers all claims that may affect the mortgagor's title (and thus the mortgage creditor's right) over the property once the mortgage has been taken. In many countries restitution claims have not yet been finally resolved, but a downgrade is only given where it is considered that there is a significant risk that they could invalidate or restrict the value of a mortgage.

3.2 Does the mortgage give priority in mortgaged property?

The grade given in this question reflects the extent to which the principle of the mortgage creditor's priority in the mortgaged property is respected outside the case of mortgagor bankruptcy/insolvency. It is considered normal for the costs of enforcement of the mortgage and taxes on the property to rank ahead of the mortgage creditor's secured claim and this does not prevent a **✓✓✓** rating.

Claims for personal injury are sometimes ranked ahead of secured claims. This does not prevent a **✓✓✓** rating as these are often not of consequent amount.

Where priority is given, for example, for other tax and/or social security claims, the rating depends on the extent of the priority.

3.3 Does the mortgage creditor have priority in bankruptcy?

This question covers two issues:

- the continued existence of the security right in bankruptcy/insolvency
- the priority of the mortgage creditor in the proceeds of sale of the mortgaged property (which may be different after bankruptcy/insolvency).

The costs of realising the mortgaged property in bankruptcy/insolvency will normally have priority over the claim of the mortgage creditor. However, where other costs of the bankruptcy/insolvency procedure take priority over a mortgage, a lower grade is given.

Where a general priority on bankruptcy/insolvency is given for wages claims and/or for tax and/or social security claims the rating is **✖✖**, but this may be raised to **✓✓** if it is limited in scope, for example to three months' outstanding wages.

A mortgage may often be set aside under bankruptcy/insolvency rules if it was granted too close to the time of bankruptcy/insolvency. This is not covered under this

question. Also, provisions under bankruptcy/insolvency laws that provide for a moratorium on creditors' rights, including mortgage creditors, do not affect the rating.

3.4 Can a third party determine whether property is mortgaged?

If mortgages are publicised through registration then a third party should be able to determine whether a property is mortgaged by examining the register. This question seeks to assess whether any third party can in principle, and in practice, discover any other mortgages that exist or may exist. A downgrade is given if access to the information is restricted (for example to persons who can show an interest in the property).

4 Enforcement of mortgage

The manner in which a mortgage can be exercised will be influential in determining its value to the mortgage creditor. The questions seek to establish the position that exists in practice, not just on a strict reading of the law, although inevitably the practice on enforcement takes time to develop.

4.1 Is the manner of enforcement of mortgage clearly established?

Enforcement may be covered by separate legislation on civil and commercial procedure with distinctions applicable to specific groups of mortgage creditors or mortgagors. Also, if relevant secondary legislation has not been adopted, the market may feel unsure about using alternative means of enforcement.

4.2 Is enforcement of mortgage rapid?

Grades are based on the estimated length of the process necessary for successful enforcement, from the commencement of the enforcement process (after any mandatory grace period) down to completion of distribution of the sale proceeds. The extent to which the enforcement procedure depends on the courts and the speed and effectiveness of the court system in general are taken into account. However, provisions under bankruptcy/insolvency laws that provide for a moratorium on creditors' rights are not taken into account.

✓✓✓	Up to 6 months
✓✓	6-12 months
✖✖	12-18 months
✖✖✖	More than 18 months

4.3 Is enforcement of mortgage inexpensive?

Grades are based on calculations of average costs for mortgage enforcement including court costs, bailiff fees, notary fees (when involved), evaluation costs, but excluding costs of legal advice. Cross-country comparison is difficult as the basis for calculating these costs varies. Costs may be evaluated as a percentage of the sale proceeds or property value, but in some countries they are calculated on the amount of the secured claim, or a mixture of both.

✓✓✓	Costs less than 2.5%
✓✓	Costs between 2.5 and 5%
✗✗	Costs between 5 and 10%
✗✗✗	Costs above 10%

4.4 Is realisation likely to be at market value?

The grades are principally based on estimates by local practitioners of the likely return on the realisation of the mortgaged property minus the enforcement costs. This question takes into account enforcement procedures but not the effect of bankruptcy/insolvency.

✓✓✓	Realisation generally at market value
✓✓	Proceeds within 80-100% of market value
✗✗	Proceeds within 80-100% of market value
✗✗✗	Proceeds constantly below 50% of market value

4.5 Is enforcement procedure simple?

The most frequent problems relate to formalistic and/or unnecessary administrative requirements, especially for establishing an executory title and for the sale procedure, and slow and/or inefficient court procedures.

4.6 Can the mortgage creditor decide on the way the sale will be conducted?

Grades on this question reflect the extent to which the mortgage creditor can, at the time of enforcement, decide on the way the sale will be conducted. Where a private sale is allowed only if the mortgagor's consent is obtained after commencement of enforcement, this is not taken into account since a mortgage creditor cannot rely on obtaining consent at this stage.

4.7 Can the mortgage creditor exercise control over the realisation process?

The question complements question 4.6, for example when the mortgage creditor cannot decide on the way the sale will be conducted but can appoint the person in charge of the sale. Where realisation is through court procedure the creditor will normally have little control, but even where it is outside the court the scope for creditor control may be limited.

4.8 Is mortgage creditor protected against mortgagor obstruction?

In any jurisdiction there is some scope for a well advised, unscrupulous debtor to delay and hamper the enforcement procedure. The question aims to assess, both on the basis of the relevant laws and procedures and taking into account reports from local practitioners, the extent to which debtor obstruction is a significant problem in practice.

4.9 Does commencement of enforcement have to be publicised?

A third party dealing with the mortgagor may want to know not only whether a mortgage has been given, but also whether it is being enforced. This information can most easily be made available through a registration requirement. If there is a significant delay before publication/registration takes place, a downgrade is given.

The requirement to advertise a public auction of mortgaged property is not counted for this purpose as the auction may happen a long time after enforcement has commenced.

4.10 Is the purchaser in enforcement procedure protected?

One of the factors that may make satisfactory realisation more difficult, particularly in the case of private sales, is the concern of prospective purchasers that the mortgagor or other creditors may be able to attack the sale and/or claim competing rights in the sold property. Where protection is only given where the sale is at public auction or it is a court-led sale, a ✓✓ grade is given. If the purchaser's title can be challenged for a certain period after the sale, a downgrade is given, which depends on the length of this period and the grounds allowed for challenge.

Annex 4: Terminology

Legal concepts have many subtle variations from one jurisdiction to another and in this work rigid definitions that are inappropriate for cross-national comparison have been avoided. There follows comments on certain key terms to help readers understand the way in which they are used in this work.

Bond – see mortgage securities

Claim/debt – these terms are used interchangeably. In civil law jurisdictions it is more usual to refer to the claim of the creditor on the debtor, whereas in common law jurisdictions it is more usual to refer to the debt of the debtor to the creditor.

Covered bond or CB – a bond where the payment obligations are secured by a pool of mortgage loans. Often CBs are provided for by specific legislation and normally:

- they are issued by a mortgage provider (or company within the same group)
- the mortgage loans remain on the mortgage provider's balance sheet.

Although CBs may sometimes be secured by public sector debt or shipping loans, this work only deals with bonds covered by mortgage loans.

Cover pool – the mortgage loans that are used to secure a covered bond.

Debt – see Claim

Enforcement – the process of exercising the right to recover the secured debt out of the mortgaged property, including establishing the right to enforce, realising the mortgaged property and distribution of the proceeds from the realisation.

Enhancement or credit enhancement – in the context of mortgage-backed securities, additional assets or rights (often derivatives or a liquidity facility) acquired by the SPV, which reduce the credit risk of the notes issued.

Mortgage – an ancillary right in immovable property entitling a creditor to recover his claim out of the mortgaged property. In legal terms it is important to make the distinction between the mortgage and the loan that it secures.

Mortgage-backed security or MBS – a mortgage security (referred to here as “note”) where the rights of noteholders are limited to the underlying pool of mortgage loans plus any credit enhancement. Features normally include:

- issue by an SPV
- an insolvency-remote structure
- mortgage loans are removed from mortgage originator's balance sheet
- noteholders have no claim against the mortgage originator.

Mortgage creditor – the person in whose favour the mortgage is granted or, where relevant, the person to whom it is transferred. Because of the accessory nature of mortgage the mortgage creditor is always the same as the person entitled to the secured debt.

Mortgage loan or debt – loan or debt secured by mortgage.

Mortgage register – the register in which a mortgage has to be registered in order to be valid or opposable to third parties. Depending on the jurisdiction this may be the title register or a separate register.

Mortgage securities – tradeable obligations where the payment obligations are secured, or otherwise supported, by a pool of mortgage loans. This includes both MBS and covered bonds. Generally, “bond” is used when referring to covered bonds and “note” when referring to mortgage-backed securities.

Mortgagor – the person who grants a mortgage. The mortgagor is always the owner of the property that is mortgaged, and most often he is the debtor of the secured claim, although sometimes one person will give a mortgage to secure the debt of someone else. In this work it is generally assumed that the debtor and the mortgagor are the same person.

Non-accessory mortgage – a mortgage which is created independently from any debt and which is used to secure claims that are defined separately. Neither the claim nor the identity of the creditor need to be known at the time the mortgage is created.

Note – see Mortgage securities

Originator – the lender who makes available a mortgage loan to a borrower.

Owner – generally used to indicate the person who has the primary right to use, alienate and derive income from a property.

Pledge – is used generally for charge over movables (including intangibles), and not in the restrictive sense of a charge with dispossession.

Realisation – in the context of mortgage enforcement, the process by which money is generated out of the mortgaged property in order to repay the secured claim. In most cases this involves the sale of the mortgaged property.

Special purpose vehicle or SPV – a company or other legal entity created specifically for the purpose of issuing mortgage-backed securities.

Title – the extent of an owner's rights in a property. Where property is registered the right of ownership, and any limitations or reservations on that right, are normally set out in the register.

Title register – the register where the title to a property is recorded. This can be different from the cadastre, which contains primarily records of a descriptive nature (including property type, location, boundaries, and so on).

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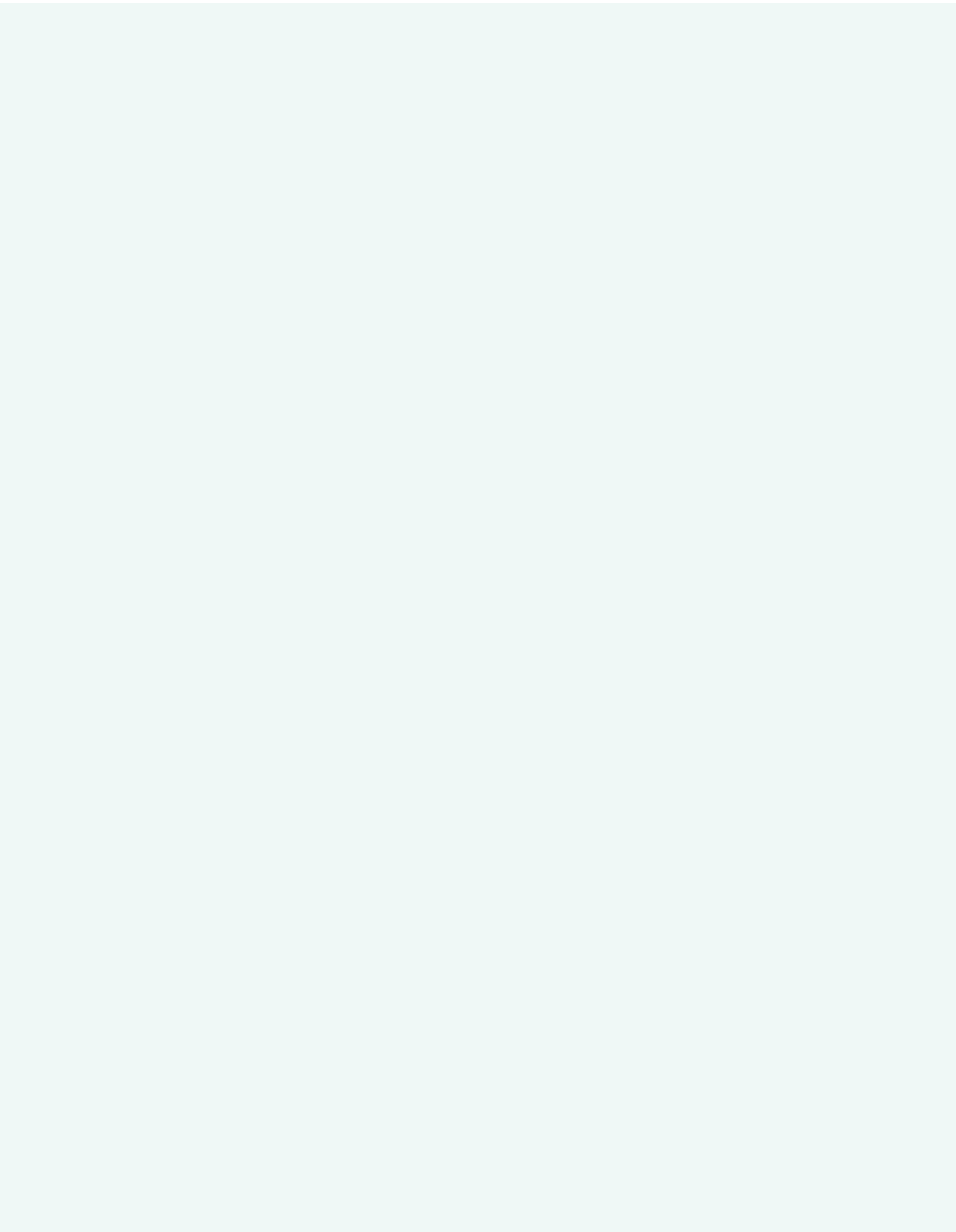
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