# HOUSING FINANCE STRATEGY FOR BULGARIA WORKING PAPER

Prepared by

H. Beth Marcus
FannieMae

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# ABSTRACT

The Bulgarian government has identified the creation of a new system of housing finance as one of the most important ways to overcome Bulgaria's housing problems. This Working Paper is intended to stimulate discussion among Bulgarians and their advisors. It contains a variety of specific options to provide choices as well as to lay the foundation for additional ideas. These options address immediate, mid-term, and long-term needs and opportunities that are translated into specific actions facilitating the creation of a market-oriented housing finance system in Bulgaria.

## EXECUTIVE SUMMARY

The Bulgarian government has identified the creation of a new system of housing finance as one of the most important ways to overcome Bulgaria's housing problems. This Working Paper is intended to stimulate discussion among Bulgarians and their advisors. It contains a variety of specific options to provide choices as well as to lay the foundation for additional ideas. These options address immediate, mid-term, and long-term needs and opportunities that are translated into specific actions facilitating the creation of a market-oriented housing finance system in Bulgaria.

BACKGROUND

In the last five years, the number of banks in Bulgaria changed from four to over 80. Only one of these banks, the State Savings Bank (SSB), was created to originate mortgage loans. Although almost all banks now have the authority to be housing lenders, the SSB remains the only housing lender in Bulgaria.

The SSB also has the largest share of deposits - over 80% of household deposits and over 60% of total deposits. Other banks have started to attract deposits and eventually should take some of these funds away from the SSB. In addition to using these deposits to fund housing, the SSB makes loans to other lenders and is an active depositor in the interbank deposit system.

Other financially-related changes are also taking place. Insurance companies are being formed and, in 1993, there should be a law authorizing private pension funds. Another change is the start of a securities market; the government has been very successful in issuing treasury securities and a secondary market for these instruments is starting.

The economic forecast for Bulgaria remains concerning. Inflation in 1992 is expected to be at least 80%. Unemployment continues to increase. The government's projections for 1993 are not yet available but they expect high inflation and unemployment to continue.

OBSTACLES TO COMPETITION

The creation of a market housing finance system must be accomplished within the framework described above. Within this framework, and based upon interviews with over 30 public and private officials, the following issues were identified as impediments to lender participation in housing finance:

- Demands on funds for more profitable purposes
- Difficulty in matching funds for long-term housing loans with short-term funding tools

- o Credit risk concerns and lack of market demand
- o Lack of staff expertise and cost of setting up a mortgage operation

The proposals offered in this paper address each of these impediments. The first two items are covered in sections relating to the mobilization of funds. The third item is covered under credit risk issues. Lastly, the fourth item relates to the creation of market origination and servicing standards.

## ACTIONS RESPONDING TO THESE OBSTACLES

The housing finance strategy proposed in this paper is in three stages: immediate (no later than 1993), mid-term (starting around 1998), and long-term (starting around 2003). The strategy is designed to utilize existing housing finance opportunities in ways that create competition and eventually, when capital markets permit, expand the availability of funds for this system. Because these proposals are dependent upon economic predictions, mid-term and long-term activities in particular will require reevaluation as the markets change.

### Immediate Actions

- o Mobilization of Funds

  If possible, housing lenders should fund the mortgages they originate using monies from deposits made to their bank. If, however, lenders other than the SSB are unwilling to use these deposits this way - perhaps due to other more profitable demands or concerns on duration matching - then an option would be to use SSB funds for this purpose. SSB funds could be directed towards other lenders using current procedures, such as direct SSB loans, interbank deposits, or SSB loans to the Bulgarian National Bank (BNB) and then BNB loans to lenders. Or, the SSB could purchase loans originated by other lenders who would then act as servicers, retaining credit risk.

- o Market Origination and Servicing Requirements and Procedures

  To ensure proper standards, market origination and servicing requirements should be prepared with advisory assistance. Lenders funding loans with their own monies would, of course, have the right to vary from these standards. However, lenders using funds from the SSB or the BNB would be required to follow these intermediaries's requirements. To further reduce costs, technical hands-on assistance would be provided and existing computer systems used wherever possible.

  Technical assistance in construction lending is also recommended. This assistance should be both in program design as well as hands-on training.

- o Credit Risk Issues

  Credit risk should be reduced through origination and servicing standardization. Lenders should be required to retain credit risk on loans they originate. However, if credit concerns become an insurmountable obstacle due to the current economic instability, the government may need to take on a more active role as a mortgage insurer or other form of credit enhancer.

- o Incentives

  Lenders should receive tax and capital reserve requirements incentives to encourage their participation in a housing finance system.

Mid-Term Actions

- o Mobilization of Funds

  An intermediary would be established to create bonds or mortgage-backed securities (MBS) for sale to investors. This company would be owned by participating lenders and possibly the government and/or an international donor such as the European Bank for Reconstruction and Development or the International Finance Corporation. Bonds would be used by the intermediary to fund loan purchases or loans it makes to its members. MBS could be issued from loans in the intermediary's portfolio as a way to raise cash or could be given back to a lender in exchange for the lender's mortgages, in which case the lender could choose to sell the MBS or hold it in its portfolio for liquidity purposes. Investors for these bonds or MBS would be traditional investors of longer-term instruments, such as insurance companies or pension funds.

- o Market Origination and Servicing Requirements and Procedures

  The intermediary would require all loans backing bonds or MBS to meet its standards. The intermediary would implement a quality control process to ensure compliance and would also conduct training for its lenders.

- o Credit Risk Issues

  If possible, the bonds or MBS should be backed only by the issuer, which in turn is backed by its owners and the quality of the loans. However, the market may require greater protection - at least in the beginning. If necessary, the government may have to assist with some form of backing or credit enhancement.



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Long-Term Actions

The purpose of the long-term recommendation is to reduce government involvement in housing finance. In addition, a second intermediary could be considered to instill greater competition in the system.



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## HOUSING FINANCE STRATEGY FOR BULGARIA
## WORKING PAPER

### INTRODUCTION

Nikola Karadimov, the Minister of Territorial Development, Housing Policy and Construction (MOC), has identified a new system of crediting (housing finance) as one of the most important ways to overcome Bulgaria's housing problems. Minister Karadimov's comments were included in a recent article in "168 Hours BBN", the English language Bulgarian business newsletter. This article also described the housing problem as being a "crisis" requiring billions of levs, much more than the 400 million levs included in the 1992 budget.

The development of the new system referred to by Minister Karadimov is the focus of this paper. This new market-oriented housing finance system would bring funds to housing from private sources rather than placing additional strain on the budget. The US Agency for International Development (AID) is working with the MOC, the Bulgarian National Bank (BNB), and others in public and private sectors to assist Bulgaria in its development of this system to replace the previous state-run system.

This working paper is intended to be used to stimulate discussion among Bulgarians and their advisors. It contains a variety of specific options to provide choices as well as to lay the foundation for additional ideas. These options address immediate, mid-term, and long-term needs and opportunities.

In the end, the decisions must be made by Bulgarian officials. This consultant supports the concept of a Working Group, consisting of Bulgarian representatives from public and private sectors and assisted by AID advisors, which would have the responsibility for recommending a framework for a market housing finance system.

### BACKGROUND

**The Current Housing Finance and Banking System**

During the last five years, the banking system in Bulgaria has experienced significant change. In this short time, the system went from having only four banks to over 80 banks. If the World Bank-assisted BNB bank consolidation project meets its target, these 80 banks will be merged into five to ten banks within the next three to five years.

Until 1989 when most of the 80 banks were created by separating branches from the BNB, the only bank with authority to originate housing loans was the State Savings Bank (SSB). The Stroybank had been created in 1987 to facilitate construction lending. However, the Stroybank's



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loans were working capital loans to construction industries and not loans to finance actual project development.

Since 1989, almost all banks have universal charters which would permit them to enter into the housing finance field. Other than the SSB, there are no banks in Bulgaria offering housing or construction loans. Instead, the commercial banks lend to businesses, providing short-term working capital loans. Although these loans are intended to cover materials and operating costs, many of the loans are collateralized by residential housing, making them technically "mortgages".

In addition to being the housing lender, the SSB was created to be the depository of household demand and savings accounts. Official figures give the SSB over 80% of all of these deposits. When other deposits are considered, such as corporate accounts, the SSB's share of all deposits is estimated to be between 60 to 65%.

The creation of 59 commercial banks with universal charters has resulted in movement of some of the household deposits away from the SSB. Although the SSB has the advantage of having the only government guaranteed deposits in the banking system, the other banks have been able to compete through pricing and service to attract customers.

In spite of the SSB's new competition for funds, the SSB remains the major holder of funds and, as a result, a primary lender to other banks. This is accomplished in several ways. The SSB lends to the BNB which in turn lends to the banks. The SSB also lends directly to other commercial banks. Finally, the SSB has a major role in the interbank deposit system by using its excess funds to support the deficits of other institutions.

**Related Financial Activities**

Bulgaria's shift from a centrally planned economy to a market economy has opened up many new opportunities in financial areas. In particular, changes are occurring that eventually will create new investors and investment tools that could facilitate housing finance on a mid-term and long-term basis. Because the purpose of this paper is to propose strategies that respond both to the immediate and future needs, a discussion of these activities is included.

In those market economies with the greatest efficiencies in housing finance, the system is able to take advantage of many funding sources. Funds from deposits will continue to provide much financial support. However, these deposits rarely match the maturity of mortgages. For this reason, other investors attracted to longer term instruments can provide important additional sources of capital.

The typical investor for these instruments are insurance companies and pension funds. In Bulgaria, the insurance industry is beginning to develop and a law regulating this industry is expected to be enacted soon. Private pension funds have not yet begun; however, work has begun on their development and legislation is expected in 1993.

Although the insurance companies do not yet have sufficient funds to invest in housing finance, their executives reacted very positively to the creation of investment vehicles that would assist them in their match funding of long-term life insurance policies. The lack of alternative instruments provides housing finance with an important opportunity to work with these companies, be ahead of the market, and design an instrument attractive to both industries.

Another important activity is the introduction of a securities market - both on primary and secondary market levels. The BNB is now authorized to hold at least two auctions a month for treasury securities. Banks use these securities as collateral for BNB loans as well as for income purposes. Lately, the terms of these securities have lengthened; the last auction was for six-month bills and these proved to be very popular. In the near future, the Ministry of Finance (MOF) intends to authorize the BNB to auction one-year instruments.

Two stock exchanges already exist which could make a market in these securities. Already, there has been one reported trade. Although this activity is just beginning, the creation of a securities market through the use of treasury securities should create a positive reception for housing securities if such instruments are created in the future.

## Economic Expectations

The Agency for Economic Coordination and Development (AECD), a government agency analyzing economic information, projects inflation in 1992 to be around 80%. In May, 1992, the official government figures showed monthly inflation to be 12% - much higher than the monthly figure needed to keep inflation within the 80% range. June figures were down to about 6%. These figures indicate that inflation remains high and volatile.

Other government statistics provide further evidence of an unstable economy, with particular impact on wage and employment issues. In May, the government estimated the decline in production to be 20% and unemployment to be a little under 500,000. Unemployment figures are expected to continue to increase with a projected 750,000 Bulgarians seeking work by the end of the year.

Others believe these figures to be even worse. Trade unions are quoted as suggesting inflation in May was closer to 40%. These same unions charged that production declined much more than 20% and that unemployment is closer to 650,000 than 500,000.

The AECD was reluctant to project actual inflation figures for 1993. However, their expectation is that Bulgaria will continue to experience high inflation and unemployment.



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STRATEGY

### Obstacles to Competition

A separate paper on obstacles to competition has been produced for AID and is attached to this working paper. Based upon over 30 interviews held by this consultant with a variety of public and private officials from July 5 through July 17, 1992, the following issues were identified as impediments to lender participation in housing finance:

- o Demands on funds for more profitable purposes
- o Difficulty in matching funds used for long-term housing loans with short-term funding tools
- o Credit risk concerns and lack of market demand, particularly as they relate to affordability and unemployment problems
- o Lack of staff expertise and the cost of setting up a mortgage operation

The proposals offered in this paper address each of these impediments. The first two items are addressed in the sections relating to the mobilization of funds. The third item is covered under the discussions on credit risk issues. Lastly, the fourth impediment relates to the creation of market origination and servicing requirements and procedures.

It should be noted that this paper focuses on mortgage lending, not construction lending. If affordable housing loans become available, then lenders should be willing to offer construction finance that will be "taken-out" (paid-off) by these loans. For this reason, the discussion on construction lending is minimal.

### Goals Selection

Before designing a system, there must be agreement on what the system is expected to accomplish and also what is feasible. The Working Group should develop a list of objectives to aid them in the development of a framework for this system.

To assist the Working Group and provide a basis for the options contained in this paper, a list of proposed goals is contained below. This list was developed based upon experience in market systems and direction from AID to "identify and prioritize immediate, medium-term and long-term actions and include recommendations on how to stimulate competition."

- o Design a system that overcomes the impediments noted above.



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- Create a competitive and financially rewarding environment that attracts lenders to the system.

- Offer a mortgage product that is as affordable as possible within the constraints of the second bullet above.

- Involve minimal government support. When the government is involved, use the government as a catalyst for private initiative and, wherever possible, in an evolutionary and temporary role.

- Take advantage of all market opportunities to direct funds to housing finance.

- Minimize credit risk.

- Develop a framework that addresses immediate, mid-term, and long-term opportunities and then constantly review and modify the framework to reflect economic and market changes.

- Make the system as simple as possible.

**Strategy Stages**

As noted, this consultant has been asked to identify immediate, mid-term, and long-term actions that comprise a housing finance strategy. Immediate is defined as beginning by 1993; mid-term is considered to start from five to seven years later; and long-term is expected to start at least 10 years after the system's inception.

The strategy described below is designed to utilize existing housing finance opportunities in ways that create competition and eventually, when capital markets permit, expand the availability of funds for this system. The paper attempts to propose actions for each of these stages based upon the current financial structure in Bulgaria, including the expected changes and opportunities described above.

The future financial developments in Bulgaria will greatly impact the proposals made in this paper - particularly those intended for mid-term and long-term actions. Because it is impossible to predict what these developments will be, it becomes equally difficult to ensure that the proposed mid-term and long-term actions will remain appropriate. In particular, it is possible that the private market will take over once a market-oriented housing finance system starts and that no other initiatives or assistance on the part of the government or its advisors will be required. For this reason, it is critical that mid-term and long-term ideas be reconsidered and, if appropriate, modified as the time for implementation gets closer.



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## IMMEDIATE ACTIONS

The SSB is committed to continue as a mortgage lender. The challenge is to attract at least one other lender to the system.

The system that is designed must ensure that the SSB and other lender(s) originate and service loans in accordance with market procedures. This system also should attempt to utilize existing financial capabilities and structures so that it is operative as soon as possible.

**Mobilization of Funds**

The current economic environment makes a large scale housing finance system on a non-subsidized basis unlikely. With interest rates in the 50 to 60 percent range, the most affordable loans are those with terms of at least 15 to 20 years and with payment ceilings and capitalized interest, such as the Dual Indexed Mortgage (DIM). However, unless there is an entity - such as the government, insurance companies or pension funds - able and willing to delay their return of funds resulting from this capitalization, this type of mortgage is not workable. Also, even if the DIM is used, the large variance between most salaries and market housing costs limit the number of people who could qualify for a loan using market underwriting methods.

Additional work is already planned for the development of a mortgage product that addresses the affordability objective while providing financial incentives for lenders. Realities of the current environment, however, suggest that whatever is designed will have a limited audience. Thus, the initial number of borrowers may be small, as will be the demand for funds.

The SSB should be able to meet market needs easily with its existing deposit base. Also, due to the SSB's asset size, it should be able to overcome in the first stage problems associated with the lack of match-funded vehicles.

With the growth in deposits in commercial banks, many of these banks should also have adequate funds for housing - if they choose to apply the funds this way. However, two of the impediments to housing finance noted above may prevent this from happening in the near future: 1) competition for these funds by more profitable loans; and 2) difficulty in matching funds used for long-term housing loans with short-term funding tools.

As an example, the Bulgarian Post Bank has expressed interest in originating housing loans. They probably will not be able to implement this program very quickly, however, due to funding problems. This is because this bank expressed its intent to use a contract savings program and, for a contract savings program to work, the targeted deposit base must be built up over a period of time.

Although the first option for funding sources should be from individual bank deposits, there should be a strategy for finding other sources if this does not evolve. One option if commercial bank deposits are not available for housing purposes is to utilize SSB deposits. The attached



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Chart I depicts these alternatives. Option A represents the first option using individual bank deposits only. Option B offers different ways for other banks to use SSB deposits.

There are several reasons to look to the SSB. The SSB has the largest deposit base, the most housing finance experience, and the government's backing as a housing lender. Through loans to the BNB, other lenders, and the interbank deposit system, the SSB is already providing funds to other lenders for their respective lending activities. The only difference between the proposal in this paper and what is current practice is that some of these funds would be required to be used for housing finance.

The SSB funds could be accessed in several ways. The existing programs could be used as long as they are directed to housing loans originated and serviced following established market-oriented standards. As examples, the loans or interbank deposits made to other banks could be specifically tied to the mortgages originated by these banks. BNB loans could also be tied to housing lending on a basis that is proportionate to loans it receives from the SSB. In all these examples, the SSB or BNB would require evidence that the amount lent or placed on deposit was used to fund mortgages meeting SSB or BNB standards.

Another way to use SSB funds is for the SSB to purchase housing loans originated by other lenders, along the lines of the loan purchase transactions between US primary lenders. Also like US lenders, the SSB would have a department or subsidiary separate from its origination department responsible for these loan purchases. Selling lenders would be required to retain credit risk and to originate and service the loans under the same market procedures and requirements that the SSB applies to its loan originations.

## Market Origination and Servicing Requirements and Procedures

A market housing finance system requires the use of prudent origination and servicing standards. Loans must be underwritten to ensure the borrower has the ability and willingness to pay and the property has sufficient value to support the loan. The servicing process is equally critical to ensure loan quality.

To facilitate this process, hands-on technical assistance will be required. This assistance must be offered not only to the SSB but also to other lenders to encourage their participation.

This assistance should help overcome the lack of experienced staff. As much as possible, it should be also focused on reducing operational costs. By using standard forms and procedures, the lenders will not have to spend time and money developing these materials. Also, existing origination and servicing computer packages could be accessed and modified to streamline the process and lower set-up costs.



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Although these comments apply to mortgage loans, construction lending also warrants technical assistance. There does not appear to be experience in Bulgaria with market construction lending. Assistance is needed both in developing standards and in training lenders and developers on the application of these standards.

**Credit Risk Issues**

There are three possible ways to address credit risk concerns:

- price for the risk;
- enforce strict underwriting and servicing requirements; and
- share the risk.

Pricing for risk is extremely difficult to do even with the best historical information upon which to base the risk premium. In Bulgaria, this is not a feasible option at the current time because statistical data on delinquencies using market lending procedures does not exist.

Wherever possible, credit risk should be handled through good underwriting and servicing. The technical training assistance noted above should facilitate this type of risk protection.

Standardization of requirements also minimizes credit problems. If all or part of Option B is implemented, the funding intermediary (SSB or BNB) should set standards for loans financed through these activities.

Sharing risk is another option. This doesn't reduce risk; it simply spreads it around. Because neither an insurance system or other credit enhancement vehicle is likely to be created in Bulgaria in the near future, the only entity that may be able to share the credit risk with lenders is the government. This could be accomplished possibly through a mortgage insurance program or through the purchase of a subordinated share of the mortgage.

This paper does not recommend that the government initiate either of these "shared-risk" options. If at all possible, lenders should be responsible for taking all of the credit risk; this generally enhances the quality of their underwriting and servicing. However, if the issue of credit risk becomes an insurmountable obstacle to lender participation due to their concerns regarding the current economic instability and rising unemployment, the government may want to consider offering an interim credit enhancement program.

**Incentives**

Governments in countries with market housing finance systems often provide some form of tax, capital reserve, or other type of incentive to encourage an affordable housing finance system. Such activity might be appropriate also in Bulgaria. During the first stage of the housing finance



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strategy, the government might consider encouraging lenders to originate mortgage loans through:

- o tax incentives, such as an initially lower tax rate on profit from mortgages, capitalization of fee income over the loan term, and upfront deduction of expected losses (bad debt loss reserve provision); and

- o capital reserve incentives, such as implementation of the Basle Accord that gives mortgage loans a 50% reduction in capital reserve requirements.

**Immediate Action Summary**

In summary, options recommended for consideration for the immediate term are as follows:

- o Mobilization of Funds

  If possible, housing lenders should fund the mortgages they originate using monies from deposits made to their bank. If, however, lenders other than the SSB are unwilling to use these deposits this way - perhaps due to other more profitable demands or concerns on duration matching - then an option would be to use SSB funds for this purpose. SSB funds could be directed towards other lenders using current procedures, such as direct SSB loans, interbank deposits, or SSB loans to the BNB and then BNB loans to lenders. Or, the SSB could purchase loans originated by other lenders who would then act as servicers, retaining credit risk.

- o Market Origination and Servicing Requirements and Procedures

  To ensure proper standards, market origination and servicing requirements should be prepared with advisory assistance. Lenders funding loans with their own monies would, of course, have the right to vary from these standards. However, lenders using funds from the SSB or the BNB would be required to follow these intermediaries' requirements. To further reduce costs, technical hands-on assistance would be provided and existing computer systems used wherever possible.

  Technical assistance in construction lending is also recommended. This assistance should be both in program design as well as hands-on training.

- o Credit Risk Issues

  Credit risk should be reduced through origination and servicing standardization. Lenders should be required to retain credit risk on loans they originate. However, if credit concerns become an insurmountable obstacle due to the current



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economic instability, the government may need to take on a more active role as a mortgage insurer or other form of credit enhancer.

- Incentives

  Lenders should receive tax and capital reserve requirements incentives to encourage their participation in a housing finance system.

MID-TERM ACTIONS

Mid-term actions are those actions expected to occur no earlier than five years after the implementation of immediate actions. These actions are designed to take advantage of financial changes and opportunities in Bulgaria.

When inflation begins to diminish and employment starts to stabilize, housing demand should increase. This in turn will result in a greater need for more competition among mortgage lenders.

The mid-term strategy looks for ways to increase lender participation and to make more funds available for housing. To do this, the strategy tries to take advantage of projected changes in financial markets and industries.

**Mobilization of Funds**

As noted earlier in this paper, several changes in the financial industries have started to take place. Specifically, insurance companies have started operations; these companies already recognize that, in the future, they will need to match their life insurance policies with long-term investments. Although the other typical buyer of such instruments, pension funds, do not yet exist in the private sector, within five years this industry should also be part of the marketplace.

In addition to potential investors, the market acceptance of securities has begun, as demonstrated by the popularity of treasury securities. A secondary market in such securities should grow in the next five years.

The mid-term strategy is intended to marry the expected increase in demand with investor acceptance of and interest in longer-term investment vehicles. Mortgage-backed bonds or mortgage-backed securities (MBS) may offer ways to bring more funds to housing finance through sales to targeted investors. Chart II depicts the system proposed using these investment instruments.

A mortgage-backed bond is a bond collateralized by mortgages. A pre-determined schedule of payments is designed upfront and the investor is paid according to this schedule regardless of



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the underlying mortgage activity. A bond can be repaid in different tranches or series, each with a different maturity date.

A mortgage-backed security or MBS is a pass-through security where the investor receives principal, including principal repayments and curtailments, and interest due on the underlying mortgages. Because the borrower pays monthly, the investor, who owns an undivided interest in the pool of mortgages, gets paid monthly.

Bonds or MBS are easier to sell than individual mortgages. They provide a larger volume with risk spread among more loans in more geographic regions. These attributes increase their liquidity, which makes them more attractive to potential non-lender investors. This also is an incentive for commercial banks who may have sufficient deposits to fund the mortgages but want these mortgages to be liquid assets.

Each lender could create their own securities for sale in the secondary markets. However, this approach diminishes the liquidity advantages obtained through large volumes. Also, if there is one issuer, then there is one set of standards for an investor to understand. If each lender issues securities, the investor will have to learn about each lender's standards. This discourages demand since, given two equal investments, the investor is likely to choose the one that is simpler to understand.

For these reasons, one securities issuer is recommended, at least in the mid-term stage. This issuer would create one type of security which results in greater volume and thus greater liquidity.

The issuer could be a government agency. However, if at all possible, an intermediary could be created that is owned by the lenders utilizing the services of the issuer. Potentially, the lender ownership intermediary could receive some capitalization assistance from international donors such as the European Bank for Reconstruction and Development (EBRD) or the International Finance Corporation (IFC). In addition, if the SSB takes the role of a buyer of loans during the initial stage, then the SSB loan-buyer function, including staff and facilities, could be sold to this new securities issuer.

### Market Origination and Servicing Requirements and Procedures

The securities issuer would be responsible for creating standards for underwriting and servicing the loans behind the securities. They would also implement quality control standards to ensure that these requirements are followed. Lenders would still be responsible for losses incurred on failed loans.

The issuer would continue the role started by AID in the first stage of training lenders in market housing finance techniques. This activity would be analogous to the continual customer training activities offered by US issuers, such as Fannie Mae, or by US trade associations, such as the Mortgage Bankers Association.



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**Credit Risk Issues**

When investors compare treasury securities with securities created to fund housing finance, they will note a major difference in credit risk. In the case of treasury securities, the government is guaranteeing payment. In the case of mortgage bonds or securities, the quality of the mortgages and possibly the issuer or lenders provide the only protection against credit risk.

The investor should receive a higher yield on the mortgage instruments to offset the additional risk. However, to make these securities more liquid, and the mortgages more affordable, the government may wish to consider enhancements which imply some level of government support. Possibly, the government could buy subordinated pieces of the security, thus taking the top loss portion. If the government provides credit enhancement, the government may want to own part of the issuer company.

Incentives

There are many ways that the government could encourage investment in mortgage-backed bonds or MBS such as:

- Reduced, deferred, or eliminated taxes on the income derived from these instruments. There is some precedent for such tax incentives in Bulgaria; at one time, there were bonds similar to US savings bonds that were tax exempt, and treasury bonds sold to commercial banks are tax free.

- Reduced capital reserve requirements. Especially if the securities have some implicit government backing, a reduced capital reserve requirement might be appropriate. For example, Fannie Mae securities are treated by US and international regulators as having lower risk than individual mortgages.

- Use as collateral for BNB loans, with preferred overcollateralization treatment. Currently, treasury securities are treated this way by the BNB.

- Unlimited investments by insurance companies, pension funds and commercial banks. Most governments place limitations on the share of a particular asset. Mortgage-related instruments could be partially or fully exempt from such limitations.

**Mid-term Action Summary**

In summary, options recommended for consideration for the mid-term are as follows:

- Mobilization of Funds



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An intermediary would be established to create bonds or MBS for sale to investors. This company would be owned by participating lenders and possibly the government and/or an international donor such as the EBRD or IFC. Bonds would be used by the intermediary to fund loan purchases or loans it makes to its members. MBS could be issued from loans in the intermediary's portfolio as a way to raise cash or could be given back to a lender in exchange for the lender's mortgages, in which case the lender could choose to sell the MBS or hold it in its portfolio for liquidity purposes. Investors for these bonds or MBS would be traditional investors of longer-term instruments, such as insurance companies or pension funds.

- Market Origination and Servicing Requirements and Procedures

  The intermediary would require all loans backing bonds or MBS to meet its standards. The intermediary would implement a quality control process to ensure compliance and would also conduct training for its lenders.

- Credit Risk Issues

  If possible, the bonds or MBS should be backed only by the issuer, which in turn is backed by its owners and the quality of the loans. However, the market may require greater protection - at least in the beginning. If necessary, the government may have to assist with some form of backing or credit enhancement.

- Incentives

  Investors should receive some tax or reserve incentives to encourage their interest in these securities. Additional incentives could be provided to lenders in areas such as capital reserves and collateral requirements.

## LONG-TERM ACTIONS

The intent of long-term actions will be to minimize the government involvement that was necessary to "jump-start" the housing finance system during the immediate and mid-term stages. This stage would produce a natural evolution to a completely market environment.

### Mobilization of Funds

Ownership of the issuer company would revert to the public through sale of shares owned by the government and participating lenders. If possible, a competitor to this company would be created. This option is depicted in Chart III.



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In the long-term, there may also be additional investors for the mortgage securities. Mutual funds, in particular, may help address the growing demand for housing finance expected in ten years.

Along with the new investors, there may be a need for new securities instruments. Today, insurance companies already recognize the need for different term investments. Long-term prospects may provide an opportunity for the development of instruments that create tranches with a variety of terms and cash flow options. Investor comfort with the intermediaries may also open up the market for uncollateralized corporate bonds; these bonds perform similarly to the mortgage-backed bonds except that the corporation's promise to repay is the only "collateral" for the bonds.

### Market Origination and Servicing Requirements and Procedures

Market standards should be well-incorporated into the system at this point. However, the market and competition should be open to mortgage product variety. The private market should be able to design appropriate requirements for these new mortgages.

### Credit Risk Issues

In order for the mortgage industry to get off the ground in the first stage and for the securities industry to be competitive in the second stage, the government may have to provide some form of credit enhancements. In the last stage of this strategy, the government should be able to reduce or eliminate its role as a credit enhancer.

### Incentives

Some of the tax incentives may no longer be needed to encourage investment in housing finance. If the government is no longer implicitly backing the securities, it may also be appropriate to reduce the advantages offered to these securities as assets and for capital reserve purposes.

### Long-term Action Summary

The purpose of the long-term recommendation is to reduce government involvement in housing finance. In addition, a second intermediary could be considered to instill greater competition in the system.

## CONCLUSION

The proposals contained in this working paper are designed to create a competitive, market-based housing finance system in Bulgaria. The recommendations are made in response to what is perceived to be the relevant challenges and opportunities existing today and projected to exist in the future.

The primary goals for the first stage are to create competition and to introduce market standards. This will be demonstrated by having more than one mortgage originator and by implementing market origination and servicing requirements and procedures. These actions would be accomplished through the use of the SSB as a funding source for other lenders if their own deposit sources are not sufficient for this purpose. There are several ways to accomplish this, most of which are based off of current SSB programs and practices.

The second stage is designed to respond to two major changes expected to occur in the next five to ten years: an improved economy resulting in an increased demand for housing finance and a growth in long-term investors. The recommended mid-term actions provide an institutional mechanism for bringing together the mortgage demand and funding sources. The vehicle for this activity is a lender ownership intermediary that would create mortgage securities or bonds that the intermediary sells or that are sold by its member banks.

The long-term actions reflect the evolutionary nature of the housing finance system. In this stage, any major government links to facilitate the creation of the system, such as its potential role as a credit-enhancer, would end or be reduced. The intermediary created earlier would also change and become a completely publicly-owned, shareholder company.

As noted at the onset of this paper, Bulgarian officials must make the important decisions regarding the design of their housing finance system. Hopefully, this paper provides useful ideas and concepts to stimulate discussion and help these officials create the framework for this market-oriented system.



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# COMPETITION IN HOUSING FINANCE

## Introduction

The US Agency for International Development (AID) has identified a critical issue in housing finance in Bulgaria as the lack of competition. Until recently, only one bank - the State Savings Bank (SSB) - was permitted to originate mortgages used for the construction, rehabilitation, and purchase of housing. However, even though commercial banks are no longer legally prevented from entering this business, the SSB remains the only bank with housing and construction loan programs.

As long as the SSB remains the only housing lender, the Bulgarian system will not benefit from the stimulus of competition. For this reason, AID asked this consultant to assess issues relating to competition in housing finance in Bulgaria.

This paper identifies reasons why commercial banks are reluctant to enter the housing finance market. It also attempts to analyze these obstacles in ways that may present opportunities for housing finance in short-, mid-, and long-terms. These opportunities are incorporated into the proposals contained in a separate Working Paper on a Housing Finance Strategy that was prepared by this consultant at AID's request.

## Overview

To some extent, the subject of competition was raised in almost all of the more than 30 meetings held during the consultant's 10 day field trip to Sofia, Bulgaria. Based upon these discussions, the following issues have been identified:

- Demands on funds for more profitable purposes
- Difficulty in matching funds used for long-term housing loans with short-term funding tools
- Risk concerns and lack of market demand, particularly as they relate to affordability and unemployment problems
- Lack of staff expertise and the cost of setting up a mortgage operation

## Other Demands for Funds

With the exception of the SSB and interbank loans, all lending taking place in Bulgaria appears to be for commercial loans. The banks are attracted to this type of lending for several reasons:

- This is the type of lending they know and are set up to do.
- They are more confident in underwriting these loans because they can evaluate potential operating income to determine the feasibility of the proposal.
- In addition to underwriting these loans based upon expected earnings, they are able to get a variety of collateral, including materials being purchased, any physical improvements owned by the business, and a mortgage on the owner's home.
- These loans are adjustable rate loans with terms that are rarely more than one year. It is assumed that the borrower's income will also adjust based upon the increasing rise in the price of products and services provided by the borrower's business.
- The terms of these loans are more able to match the terms of the timed deposits and interbank loans obtained by the banks to fund the loans.

Although the reasons why Bulgarian lenders only lend to businesses are logical, these reasons also could be applied to construction lending, especially if there is a way to fund the long-term loans. Thus, there may be a way to use the profitability rationale to support an increase in loans to construction industries and builders.

There may be other motivations for lenders to become more universal in their lending practices. The bank merger program is designed to create 5 to 10 commercial banks that are diversified in their activities. Another incentive may arise from enforcement of international risk-based capital rules which should require higher reserves for commercial loans than for home mortgages. This will increase the profitability for housing loans as compared to commercial lending.

<u>Match Funding</u>

For housing loans to be affordable, they need to be amortized over a long time period. Generally, this means that the terms must be no shorter than 20 years. Thus, to fund the loans with a proper duration match, lenders need long-term instruments.

## Household and Business Deposits

Household and business deposits are short-term. However, the term of these deposits as well as the placement of these deposits have changed in recent months and these changes may have important implications for the future.

Most of those interviewed believe that deposits are moving away from the SSB to other lenders. The SSB lagged behind the commercial banks in raising its deposit rates. The commercial banks were successful in competing with the SSB on price and service in spite of the SSB's advantage of being the only lender with government guaranteed deposits. The lender thought to have taken away the most from the SSB is the Bulgarian Post Bank.

The aggregate volume of deposits increased in both the SSB and the commercial banks. Unfortunately, information on the number of accounts was unavailable so it is not possible to verify that the total number of household accounts in the SSB have decreased.

The published percentage of total household deposits attributed to the SSB ranges from 80 to 90 percent. However, the deposits from companies have significantly increased, and since these deposits are placed in commercial banks rather than the SSB, the estimated SSB share of all deposits is closer to 60 to 65 percent.

Perhaps the more interesting change demonstrating a move toward longer termed investments is the growth of savings accounts and timed accounts (6 months to one year) over demand accounts. In 1990, 59 commercial banks had about 9 billion levs in demand accounts and none in timed/savings accounts. By the end of 1991 there were 15 billion levs in demand accounts and 5 billion in timed/savings accounts; by May 1992, demand accounts were down to 12 billion but timed/savings account were up to 8 billion levs.

The figures for the SSB are also interesting. By the end of 1990 and 1991 and in May 1992, the SSB had 2 billion levs in demand accounts. In comparison, their timed/savings accounts had deposits as follows: 20 billion levs in 1991; 30 billion levs by the end of 1992; and 35 billion levs in May 1992.

Because the duration of the timed and savings accounts is still short, the banks still do not have funds that can be used to match the long terms of mortgage loans. However, the trend toward less liquidity by depositors is interesting and may suggest an opportunity for longer term investments.

## Compensation Fund

The parliament recently passed a law providing for compensation to some of those depositors who had funds tied up in contract savings where these funds, due to inflation, have lost their relative value. The plan is to provide a one-time additional deposit to these accounts to be used for housing purposes. Although this Fund is temporary, and there is much disagreement over how the government will pay for these additional deposits, if there is money added to the Fund, then perhaps it can be tied to a market demonstration project.

### Interbank Deposits and Loans

Another important source of funding are deposits and loans between banks. The SSB is the largest lender for these activities. The BNB has a relationship with the SSB that requires the SSB to lend to the BNB at a BNB "market" rate. The BNB uses these funds to lend to commercial banks. In this way, the SSB is indirectly funding the commercial banks. The World Bank mission leader, Hans Moritz, explained that the SSB's role in funding the BNB is the reason why the government will not likely change the SSB's charter to make it a commercial bank that is part of the bank merger program.

The SSB is also the biggest depositor for interbank deposits. Interbank deposits occur when a bank with cash excess offers its funds to a bank with a cash deficit and receives in return, in the case of Bulgaria, typically 3.5 to 4 percent over the base rate. Most of these accounts are timed deposits of 1, 3, or 6 months, (1 month is most common) with a right of renewal upon agreement of both parties. The interbank deposit program is another example of how the SSB funds are already being used to fund other lenders.

### Long-Term Bonds

Only one investment instrument appears to have a term that matches the duration of housing loans: the 20-year Treasury bond being swapped by the government for the non-performing loans to failed government industries. These bonds were issued once - at the end of 1991. The bonds pay interest only in the first five years and then amortize the principal payments over 15 years. The rate floats at a 1% spread over the BNB base rate (the rate at which the Bulgarian National Bank (BNB) lends to commercial banks). Mr. Ljubomir Velkov, head of the MOF Department of the State Treasury and Sovereign Debt, indicated that the government may issue another 5 billion levs in these bonds in 1992 to swap for bad debt on companies already in bankruptcy proceedings or where liquidations resulted in losses.

The banks are understandably willing to take such long-term bonds because they are better assets than the failed loans. The banks also prefer these assets over new loans, which has a negative impact since it discourages new lending. In addition, these bonds provide stable income, are tax exempt, and can be used for collateral for BNB loans.



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**Other Securities**

Interest in more liquid and tradable securities may suggest that in the next few years there will be more opportunities for raising funds on a longer-term basis. These indications center around the growth both of instruments with increasingly longer terms and of the industries typically investing in long-term instruments.

A market in treasury securities, in addition to the 20-year bonds described above, is beginning. The BNB, acting as the fiscal agent for the government and at the request of the Ministry of Finance (MOF), now auctions treasury bills twice a month. Thus far, they have held 14 auctions. Although only the last auction was for 6-month bills (the rest for one-month issues), the bids were for over three times the amount authorized by the MOF. Also, there have been one or two attempts by the First Bulgarian Stock Exchange to create a secondary market in these securities.

Mr. Velkov stated that the MOF intends to issue one year bonds this year. He stated that as the base rate stabilizes, the MOF intends to gradually increase the term of treasury securities.

Banks are attracted to the treasury securities for several reasons. Like the 20-year bonds, these securities are tax exempt and are acceptable collateral for BNB loans. The securities also, obviously, are considered to have a low credit risk. For a security funding housing loan to compete with these securities, some comparable benefits will probably be necessary.

Another reason for the popularity of these securities is that there are very few alternative instruments that have the potential of being liquid. This suggests that the treasury securities may help create a securities market, providing an opportunity potentially for housing loan securities.

The marketplace should become even more liquid in the next few years if the growth of long-term investors continues. These investors are typically insurance companies, pension funds, and mutual funds. Several private insurance companies have already started and a new law is pending that should help define and assist this industry. This law will most likely also include reserve requirements; if special bonds are created for housing finance, it would be beneficial if these bonds were included as eligible reserve instruments.

Private pension funds have not yet started up in Bulgaria. There is, however, a legislative proposal being drafted and those interviewed projected passage in early 1993.

<u>Credit Risk and Lacking Market Demand</u>

Although only one lender - Stroybank - mentioned credit risk as a deterrent to being a mortgage lender, Bulgaria's unstable economy, high inflation, and rising unemployment justify this concern. In addition, although interest rates are significantly under the inflation rate, these rates are extremely high, making housing loans very expensive.



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According to Rumen Avramov, Vice President of the Agency for Economic Coordination and Development (AECD), inflation in 1992 will be approximately 80%. Government unemployment estimates suggest that there will be 42 people looking for every job at the end of 1992, compared to 13 in 1991. Those outside the government believe the inflation and unemployment figures will even be worse.

New employment opportunities appear to be in the growth of small businesses. In a more stable economy, small businesses are very risky enterprises. They are probably also equally if not more risky in Bulgaria.

The same concerns that discourage lenders from making mortgage loans in this environment also affect market demand for these loans. Until there is greater employment stability, Bulgarians will be more likely to invest in businesses than in their housing. Also, the high interest rates of over 50% for loans make long-term borrowings extremely difficult.

### Set-up Costs

The cost of establishing a mortgage operation is another deterrent to the creation of a competitive housing finance market. Except for the SSB, commercial banks do not have the knowledge or staff expertise in this field. Also, these banks lack the operational structure for these loans, although they should be able to adapt some of their existing origination and servicing functions for housing finance.

The lack of a potential market due to the issue of affordability discourages lenders from entering this business. To make a program profitable, there needs to be sufficient business to justify the set-up costs and create operational efficiencies.

There is also a belief among Bulgarian lenders that in order to offer a housing finance program, the banks need large retail outlets. This may be based on economic reasons, although the concern that was expressed was that a limited branch system offering housing loans would give the appearance that the bank favored certain regions.

AID assistance can be most helpful in overcoming some of these concerns. Training and hands-on technical assistance may help overcome some of the obstacles associated with lack of experience and costs of establishing a business.

At least two lenders interviewed indicated interest in creating a mortgage operation. The most likely to participate is the Bulgarian Post Bank which was described in very positive terms in the DFC interim report as well as by staff from the World Bank, International Finance Corporation, European Bank for Reconstruction and Development, and the Bank Consolidation Company (the holding company responsible for bank mergers). The Bulgarian Post Bank discussed starting a contract savings program; however they appeared to be very interested in learning more about other housing finance programs.

The other expression of interest came from Oleg Nedyalkov, Chairman of CB Doverie Inc. (Doverie). Mr. Nedyalkov has taken the lead in working with other banks, including Stroybank which was originally created to lend for construction purposes, to merge institutions even before the Bank Consolidation Company takes action. Doverie's actions are viewed very favorably. However, even though Mr. Nedyalkov will likely have an important role in the new bank, which will be called the Bulgarian Credit Bank, he will not be in charge. The Stroybank will most likely be the "foundation bank" in this merger, and Stroybank staff were the lenders most concerned about credit risk for housing loans.

In order for there to be competition, there needs to be at least two lenders. The SSB is clearly going to be involved in a market housing finance program. If, at the beginning, at least one or two other lenders can be brought into this business, and especially if they are successful, this should stimulate other competition when the economic environment is more encouraging.



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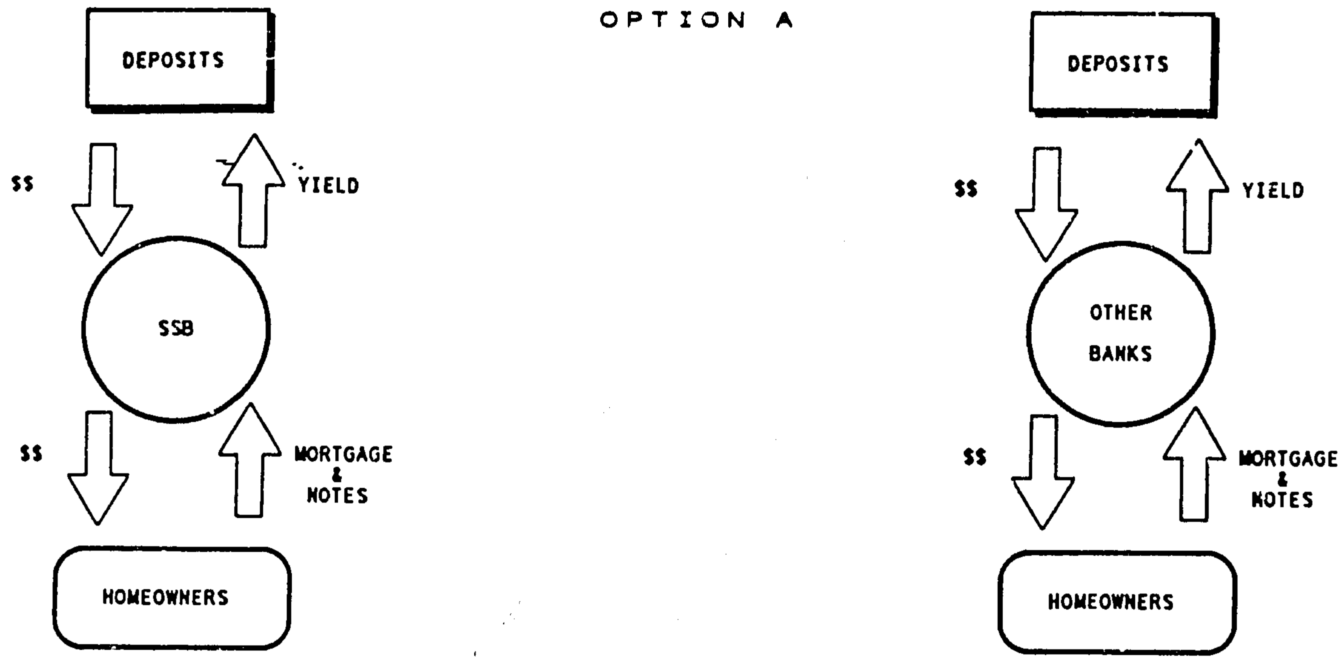
CHART I

# IMMEDIATE ACTIONS

## OPTION A

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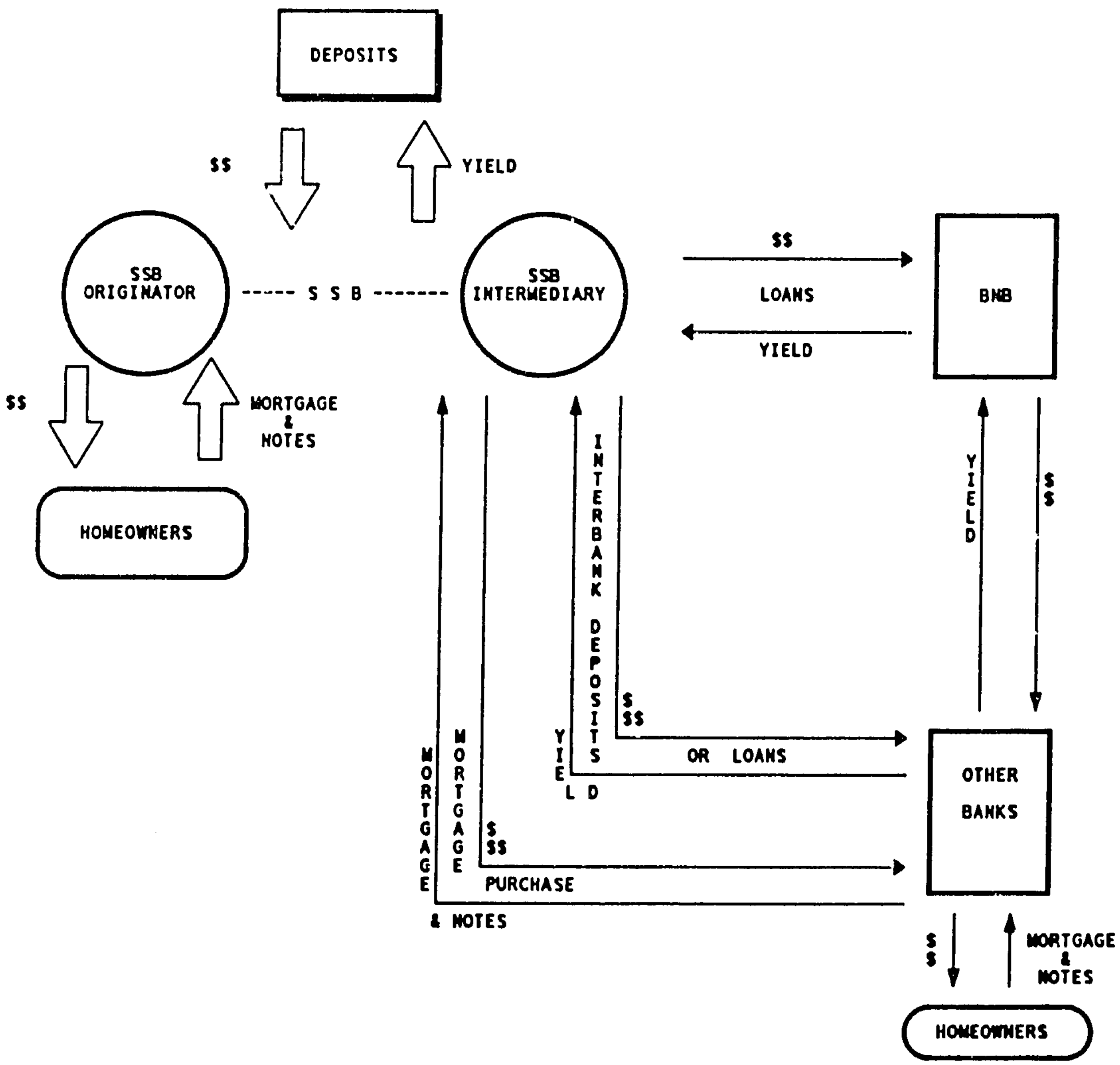


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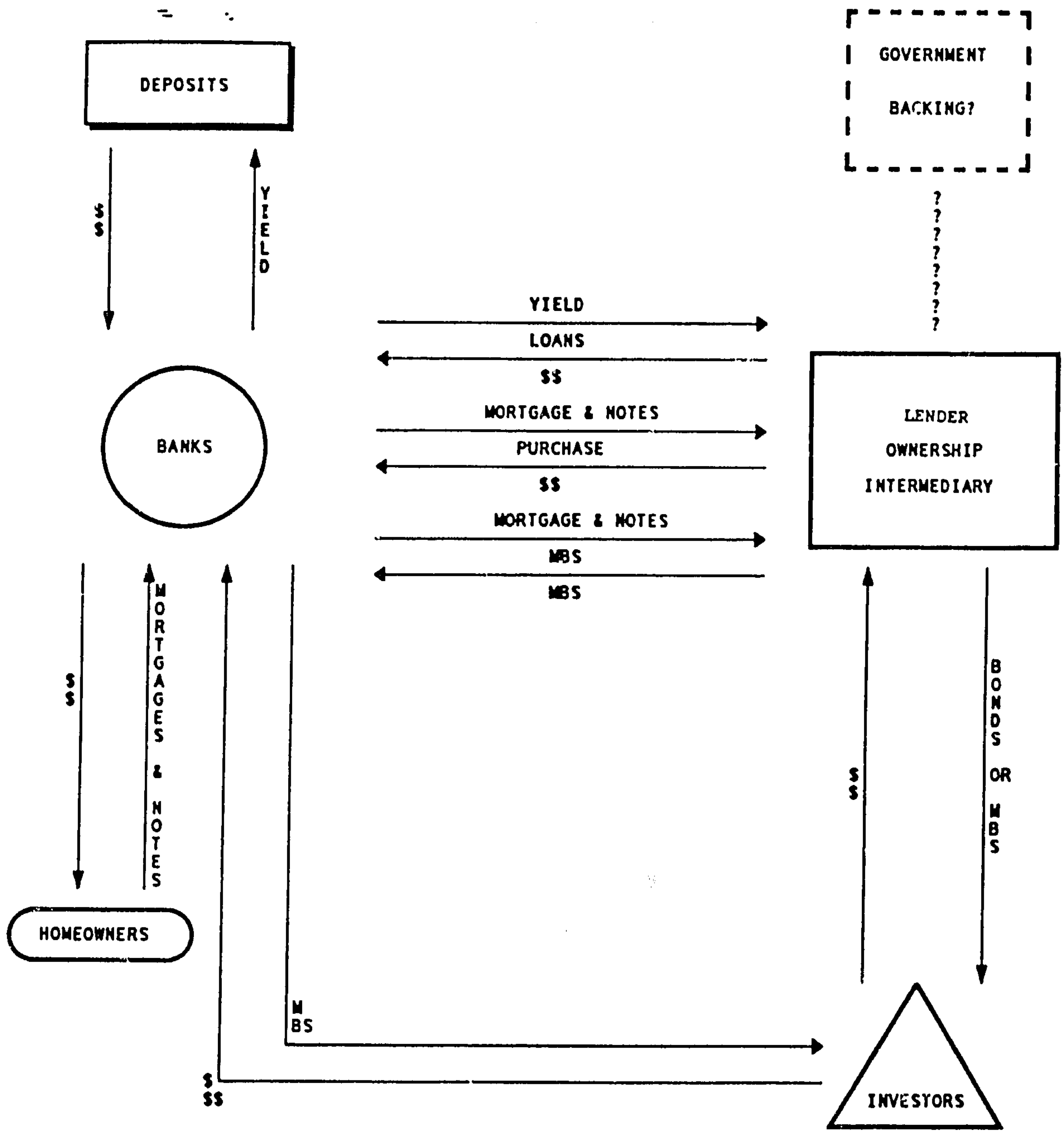
CHART

# MID-TERM ACTIONS



# LONG-TERM ACTIONS

CHART III