Housing Loan Recovery in Central and Eastern Europe: The Evolution to a Market Solution

by Christopher Banks, Douglas Diamond and Sheila O'Leary

INTRODUCTION

The countries of Central and Eastern Europe are in the process of developing housing finance systems that operate on market principles, not central plans. One of the critical steps is the transition away from loan recovery systems premised on universal employment (and power of garnishment) by the state and towards legal, procedural and cultural norms supportive of enforcement of loan covenants. Meanwhile, making housing loans without the safety net of an effective loan recovery system is planting the seeds for unknown and potentially major credit losses. This situation is made more perilous given the fragility of the region's restructuring banking sectors. As a practical matter, the weakness in loan recovery has also encouraged very cautious loan underwriting, undermining the ability of housing finance to support the broader transition to more effective housing and financial markets.

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The goal of this paper is to examine a number of mechanisms typically used to maximize housing loan recovery and the current state of their development in the more advanced, western tier of Central and Eastern European transition countries, referred to in this paper as the Central European Transition (CET) countries.[1] The second section provides a brief background on housing finance in the pre-transition period and some characteristics of current housing finance systems in the region. The third section presents the current state of risk management and loan default prevention strategies. The next section discusses a number of loan recovery mechanisms used in the region as alternatives to foreclosure. The fifth section describes the rapidly evolving legal framework for strengthening foreclosure and eviction procedures and practices. The final section offers some conclusions about the current and future development of loan recovery in the region.

BACKGROUND

Before 1989, housing loan recovery in CET countries was based on a number of economic and social assumptions unique to the socialist period. Macroeconomic conditions for the most part could be characterized as stable, including implicit employment guarantees to citizens working in state-owned or controlled enterprises which dominated national economies (except in the former Yugoslavia). This signified that the incomes of borrowers of long-term housing loans was even more reliable than in most market economies. Financing terms for housing loans were remarkably soft, including 30-year or longer loan terms and interest rates fixed at low levels unseen in other economies and made possible by state subsidies. The terms were not based on bank profitability or viability. Banks possessed an array of loan recovery tools particular to the socialist economic system, the most significant being the easy access to the garnishment of wages for employees working in public enterprises. Given the availability of such simple mechanisms for loan recovery, security of real property as collateral for loans existed mainly on paper and rarely needed to be relied on.

With the end of state control of the economy, loan recovery suddenly became highly problematic. The result is reflected today in a basic difference in the way credit risk in housing loans is viewed. In developed market-based systems, the major determinant of credit risk is the buyer's equity in the home. In these systems, 30% to 40% equity is considered to essentially eliminate risk for banks making housing loans. In CET countries, this is the starting point for home loan downpayments. After the downpayment is made, an array of tools is utilized, in addition to the pledge of property, to reduce the credit risk. Even when these tools are applied, recovery is by no means ensured and delinquency and default rates are significantly higher than in Western Europe or the United States.

The dramatically changed economic conditions in CET countries have undermined the ability of the government and state banks to continue subsidizing the housing finance system. The situation is particularly acute because there is a growing demand for financing both rehabilitation and purchase of existing housing. The number of transactions in the housing market, particularly with the ongoing or nearly complete process of housing privatization across the region generating substantial real estate sales activity, has increased considerably. On the other hand, more uncertainty now exists with respect to employment and the concurrent ability to repay housing loans. This implies the increasing need to rely more on the security of collateral in housing finance systems.

Credit Culture

An equally important, if not more important, concern is the long-term development of the "credit culture" in these countries: how credit and default are treated from a social and cultural point of view. The credit culture is important because, in most cases, loan repayment is a matter of economic choice. Even if a borrower is faced with a severe financial hardship, for example, unemployment, he usually has some options. Such options may include selling his pledged property to repay the loan and adjusting to a more affordable situation, such as renting a smaller flat or moving in with relatives. Alternatively, the borrower may simply choose not to repay the loan and face the consequences, which may vary from country to country.

A strong credit culture is a major ingredient to the success of loan recovery and the health of the financial system. When the borrower discovers that default does not result in foreclosure on the property pledged, or that the legal system protects the borrower from any major consequences, the credit culture deteriorates. An example is the recent case of loan repayment rates in Hungary. When the terms of the pre-transition housing loan portfolio (with loans fixed at 3% and 30-year terms) were changed to market rates (with 50% principal forgiveness), these loans were explicitly guaranteed by the government. The guarantee signified to the borrowers and lenders that loan delinquency or defaults would not be penalized and that the cost would be covered by the government. As a result, default rates have increased to very high levels, despite the relatively small burden these loans represent for most households.

Recent Experience

Unfortunately, exactly how weak loan recovery is in CET countries is difficult to know from published data. Banks are only now developing transparent methods of tracking and reporting defaults and managing information in ways that might permit accurate calculation of the number and volume of unpaid loans. Typically, loan default and delinquency information is tracked for a bank's entire portfolio; thus, data reflect only general numbers for the entire stock of loans, both housing and non-housing. If a distinction is made for housing loans, the data are commonly not disaggregated for age of the loan, the size, or the purpose. Only recently has more information begun to become available beyond simple categorizations as "delinquent" or "in default." In addition, even in well-developed systems, default data are often not available as public information; thus, it is not surprising that lenders are reluctant to reveal the data they do have.

Having stated these limitations, the authors have established from their various contacts in CET countries that long-term default is a large and growing problem. Rates of loans delinquent over six months are often in excess of 5% and even 10% among more seasoned loans. Since lenders in Hungary and Slovakia do not appear to employ many effective methods for ultimately assuring recovery, it is likely (and it appears in the limited data) that these rates will continue to rise as the loan cohort ages. In Croatia, the two largest housing lenders estimate loan default rates at between 1% and 1½% of their overall portfolios, suggesting that their emphasis on applying pressure on guarantors is relatively effective in the absence, until very recently, of a real foreclosure option. However, since there are few loans in the portfolio originated prior to 1994, this level of default is bound to continue to rise as the portfolio ages.

The key to minimizing credit risk is designing a system that prevents default and provides lenders an array of loan recovery options in the event default prevention is unsuccessful. The elements of such a system are effective loan default prevention and risk management strategies; loan recovery alternatives to foreclosure; and reliable foreclosure and eviction laws and procedures.

RISK MANAGEMENT

The methods of preventing default and managing risk include careful underwriting of the loan; quick response to borrower delinquency; setting loan terms to encourage borrowing only by the most secure borrowers; and allocating risk to third parties.

Careful Underwriting

One of the most important tools to prevent borrower default is for banks to institute good underwriting practices. In the countries examined for this paper, strict underwriting is, in practice, an important way to minimize default. However, the usual considerations underwriters look at, such as income and assets, credit history and employment history, have changed considerably in the transition period. This situation has led banks to be extremely cautious. In the past, credit history was not a major consideration when evaluating the risks of a borrower, as loans were typically administratively allocated by state banks or enterprises. Employment history was characterized by remarkable stability, with lay-offs or bankruptcy not part of the socialist economic vernacular.

The greatest difficulty for lenders today in this area is the general lack of credit history. This is due to the previous unavailability of consumer credit and the soft loan terms in the past, which were not difficult to repay. In most market economies, banks take advantage of the existence of credit bureaus and the like to screen out problem borrowers. This type of information is largely unavailable in CET countries, and although bankers appreciate the utility of such information, there exists a public mistrust of institutions and organizations seeking personal financial information.

Other underwriting problems will not be solved in the immediate future. Employment security is now in flux and is likely to remain that way, with much of the region's economy in the process of restructuring. As a result, income and assets of borrowers and other guarantors are closely examined, a difficult task given the size of the grey economy in these countries. Most laws in the region allow banks to claim fixed and liquid assets in the event of loan default. Also, the immaturity of the housing markets, along with widely fluctuating pricing, make property appraisal another underwriting issue for the banks. This encourages them to overcollateralize loans.

Lending Terms

Another element in managing credit risk is the imposition of lending conditions and draft terms into the loan documents that encourage borrowers to pay their debts. Low loan-to-value (LTV) ratios, high interest rates, loan acceleration clauses and penalty provisions are examples of these types of conditions. Unfortunately, the more conservative these lending terms are, the smaller the market of potential qualifying borrowers will be.

By requiring large downpayments, banks can insure that borrowers have invested a sufficient amount of their own funds to encourage them not to default on their loans and to provide the lender with assurance that the collateral protects the loan. Imposing low LTVs for housing loans is one approach typically used by banks throughout the CET region. In Poland and Croatia, LTVs are in the 60% to 70% range. In Hungary, LTVs are rarely higher than 30%. In practice, though, these low LTVs do not matter if the lender does not have the ability and will to foreclose and sell the property.

Two other alternatives that encourage borrowers to stay current with their loan payments are loan acceleration and penalty clauses in the loan documents. In most CET countries, loan acceleration allows the lender to demand full payment of the outstanding loan balance if the borrower is delinquent on a payment. Penalty clauses may be charged as flat or percentage fees charged on the amount in delinquency and usually include provisions requiring the borrower to pay all court and execution fees if the lender pursues a legal foreclosure action.

Allocation of Risk to Third Parties

One approach to managing credit risk is to shift the risk elsewhere, i.e., to third parties other than the borrower and lender. This can be advantageous but only if the benefits outweigh the cost.

In theory, many CET lenders already shift their risks to third party guarantors of the housing loan. These other guarantors, typically private individuals, promise to make repayment if the original debtor defaults. In order to make this a credible alternative, the guarantors must have a high level of income and a low level of debt. This practice also has the effect of not actually shifting the credit losses to the guarantors, but screening out borrowers with higher credit risks before they can even borrow. Usually, only individuals with relatively substantial financial resources can muster the confidence of two or three other friends with substantial resources to act as guarantors.

The guarantor requirement reduces the ability of many households to access credit and shrinks the potential market for lending. It is useful, however, for generating the special attention to a short-term delinquency to prevent it from turning into a long-term default. Banks throughout the region feel that this tool is an important and effective mechanism for loan recovery, in particular in rural areas where social pressures and personal relations to the debtor tend to play a stronger role than in urban areas. Thus, banks appear to be easing these requirements only reluctantly.

Many lenders in the region express great interest in some kind of mortgage insurance or government guarantee that indemnifies the lender in case of loss. However, mortgage insurance usually covers reimbursement for unrecovered losses after foreclosure and disposition of the property. It does not relieve the lender of the burden of pursuing all legal recourse prior to collecting on the insurance. Thus, the presence of mortgage insurance will normally not reduce the difficulties posed by legal and administrative structures poorly designed to support foreclosure, nor the adverse publicity accompanying such actions.

In fact, mortgage insurance is usually only applicable to exposure beyond some maximum loan-to-value ratio. The premise is that risk really arises only from the likelihood of the sale of the property not covering the loan, making the assumption that execution of the lien on the property is relatively straightforward. Mortgage insurance is not normally based simply on the likelihood that the borrower will have trouble paying the loan.

Mortgage insurance is commonly used in the United States and the United Kingdom because it spreads risks over a number of lenders and regions. This is especially important when a country has many small lenders operating in segmented regions. This is not important when all lenders are relatively large and operating over all regions in the country, as in most CET countries. Although state monopoly lenders are losing market share to new housing lenders in many countries, the new lenders are usually large enough to reach most regions of the country in which they operate. In these situations, it is not clear that the gains from spreading risk exceed the costs of increased moral hazard which results from the introduction of such insurance programs.[2]

There is one other possible reason why lenders may be willing to pay more than the expected amount of loss to get someone else to bear the risks. That reason is to avoid bad publicity from harsh loan recovery activities. If the insurance company is in a better position to bear that bad publicity, then there may be room for making such insurance viable. This is an attractive idea for many CET countries, where many banks fear the potential bad publicity resulting from a forced eviction and foreclosure, which to date has been pursued only in special, rare cases. It has been discussed in Hungary that a guarantee institution could be established, owned jointly by mortgage lenders. The institution would have the responsibility for foreclosing on defaulted loans presented by the shareholding banks, with losses borne by the shareholders.

There is another way of shifting risks to third parties. This refers to the risks of the underlying causes of defaults, usually physical disability, unemployment, or family crisis. It is possible to require life or disability insurance against physical ills. The government usually offers some protection, although limited, against unemployment. Some governments offer special assistance with mortgage payments. In addition, private insurers in western Europe also offer mortgage payment coverage in cases of involuntary unemployment. Marital or other family crises are more difficult to indemnify against.

Some CET countries have recently begun to implement means-tested housing allowances for low-income families. These cover both renters and owners, and could be used by unemployed owners to supplement unemployment benefits and keep current on mortgage payments. However, none of the countries has a government-sponsored benefit aimed particularly at preventing mortgage default.

Delinquency Management

Even in circumstances where a bank has performed sufficient analysis to determine a borrower is a good credit risk, circumstances will arise that prevent some borrowers from paying a loan on time. To minimize the cost to the bank and to prevent borrowers from developing poor payment habits, banks need reliable systems for tracking delinquencies and prompt and consistent response to borrower default. Most current lenders in the CET region have competent systems in this regard, with automated monitoring systems and arrearage charges which compound monthly; these deter a borrower from falling behind in payments. Some banks have developed innovative systems, such as mailing monthly notices to borrowers with payment due, just as a gas or electricity bill is sent. If payments fall more than one month behind, banks will typically contact the third-party guarantors to notify them of the delinquency and the right to call in the loan. As stated before, this usually proves an effective tool for pressuring the borrower to pay, if he can; or for the guarantors to work with the debtor or assist with payments to make the loan current. Chronic delinquency usually results in personal contacts with the borrower to determine the reason and can involve informal counseling to improve payment habits.

Such efforts can be very productive when borrowers face a binding alternative of foreclosure. However, as reflected in the high default rates, the effectiveness of prompt and personal contact with delinquents is severely blunted when the context is "cajoling" borrowers, rather than working with them to avoid more serious consequences.

Another area of potential for improvement is the analysis of past default patterns. Banks in the region have yet to develop enough sophistication about the evolution of defaults as loan cohorts age or about compiling default data in a way supportive of developing a credit scoring system to assist underwriting.

ALTERNATIVES TO FORECLOSURE AND EVICTION

For legal, social and financial reasons, lenders in CET countries are reluctant to pursue the remedy of foreclosure. In some countries the legal basis may be incomplete. In other countries, lenders may not exercise their legal right to foreclosure and eviction because it is socially unacceptable to displace families. Finally, even where an adequate legal basis exists, lenders may consider the process too lengthy or expensive compared to the loan recovery they are likely to achieve through other methods. For all of these reasons, there are a number of alternatives to foreclosure that are currently used or could be used by lenders in the CET region.

Forbearance and Renegotiation of Loan Terms

Forbearance and renegotiation of loan terms is typically considered when the borrower is experiencing temporary financial hardship because of unemployment, illness, death of an income-earning spouse, marital problems or similar reasons.

Forbearance is an agreement, usually in writing, between the borrower and lender, to suspend or reduce borrower payments for a temporary period. When the period of forbearance is over, the borrower must repay the debt forborne, usually by increasing regular monthly payments until the forborne amount is repaid.

Renegotiating loan terms may involve lowering the interest rate or monthly payment, extending the period of repayment, or modifying the mortgage instrument, for example, by changing the interest rate from fixed to variable. Lenders may require that the borrower first make good on all delinquent payments before agreeing to make modifications to the loan terms. Alternatively, the lender may allow the borrower to capitalize delinquent payments into the total outstanding loan balance.

The advantage to the lender of forbearance and renegotiation is they are much less costly alternatives than foreclosure or the other remedies discussed in this section. Particularly if the borrower has a good payment history and is only experiencing a temporary hardship, it is likely that the borrower will resume timely payments in the future and the lender suffers a negligible loss. The primary advantage to the borrower is that he is able to keep his home, and the bank will cooperate with him to get through a temporary financial crisis.

Forbearance and renegotiation of loan terms appear to be the most important tools used by CET country lenders to recover loans once they have lapsed into serious delinquency or default. Banks exercise considerable flexibility in this area, for example, making forbearance retroactive to the time of default to avoid the need for the borrower to pay unaffordable late fees; or lengthening the term of the loan by two to three years under the condition that all delinquent payments and late fees be made current. Since loan terms are typically 10 to 15 years, lengthening the term by three years can reduce payments significantly. Lenders acknowledge the importance of these tools. High default rates relative to the West along with relatively low rates of foreclosure indicate that most loans are recovered in this way.[3] It is not clear how much of a loss banks are willing to allow, and that amount is likely to vary among countries and according to the private sector orientation of the banks.

Voluntary Sale of Property

Voluntary sale of the property may be considered an option after other attempts at renegotiating the loan terms or allowing the borrower a period of forbearance have failed; or if the lender for other reasons determines the borrower is unlikely to pay the debt owed. The property owner is responsible for undertaking all necessary measures and paying for costs associated with marketing and selling the property. Sales proceeds are turned over to the lender to satisfy the outstanding debt. The seller retains proceeds in excess of the debt. If the sales proceeds are less than the outstanding debt, the lender may accept this amount or, if legally permissible, pursue a deficiency judgment against the owner for the outstanding balance. To expedite the process, the lender usually pursues the foreclosure action simultaneously with the borrower's attempts to sell the property, in the event the borrower is unable or fails to make a good faith attempt to sell the property.

Voluntary sale of property is encouraged by lenders in the region. Banks recognize the need for flexibility in this case and do not insist on collection of 100% of the loan balance, since this process is faster and cheaper to the banks than foreclosure. Several problems with this option illustrate the difficult environment in which banks attempt to recover loans in default. It appears that voluntary sale of property is often not successful because there is an element of social shame faced by potential buyers of property being sold under duress. This is more likely to be a serious problem in rural areas where residents know each other and mobility is low, meaning that a likely buyer in a voluntary sale would be someone from the same town or village. The strength of the resale market is further hindered by government policies which often favor the purchase of new housing and the lack of finance for used properties.

The concept of voluntary sale is one that is somewhat foreign. In the U.S., for example, it is generally taken for granted that if a borrower finds himself absolutely unable to repay a loan, he should sell the home and adjust to a more affordable situation. Cultural and social traditions help explain a stronger personal attachment to homes in the CET region, where many single-family homes are built with substantial sweat equity and over several years. This engenders a general reluctance to sell at almost any cost.

Deed in Lieu of Foreclosure

A deed in lieu of foreclosure occurs when a borrower transfers property title to the lender to satisfy the outstanding debt. One advantage to both borrower and lender is that this process is quicker and less expensive than foreclosure. Lenders may be particularly interested in this solution if it is unlikely there will be interested bidders at auction, and the lender will be forced to purchase the property in any event. This is essentially what happens by default to banks in CET countries when voluntary sale of property is not successful for the reasons described in the previous section.

The primary disadvantage to the lender is that a deed in lieu of foreclosure generally cannot be used when there are junior lienholders, unless those liens are satisfied. Borrowers may prefer the deed in lieu option if they have little equity in the property and transferring the title frees them from all financial obligations. The opposite is true for borrowers, like the vast majority of CET country borrowers, who have substantial equity in the property and the market value of the transferred property is higher than the outstanding debt.

Garnishing Wages

Garnishing wages is a long-established mechanism for loan recovery used throughout the CET region. However, garnishing wages may not offer lenders the same easy solution to loan recovery as in the past, as real wages remain low in relation to housing costs, unemployment rates high and employment stability is no longer ensured as it was during the pre-transition period. In addition, banks must complete a potentially lengthy court procedure required before garnishing a borrower's wages, and the level of garnishment is often regulated in the legal framework to protect the borrower from excessive collection. However, it may be appropriate in some circumstances for the borrower and lender to negotiate an arrangement whereby the mortgage payments are deducted directly from a borrower's paycheck, bank account or other source of funds on a monthly basis to make regular mortgage payments. Nonetheless, many borrowers may be reluctant to relinquish control over their finances in this way.

FORECLOSURE AND EVICTION

Residential lending is generally considered low risk because of the ability to place a lien on immovable property. This allows the possibility of seizing and selling the property, usually the residence, for at least the value of the outstanding loan. In order for this remedy to be effective, there are a number of legal provisions that are required, and a number of related provisions that are typically included in the relevant legal framework to provide relative advantages or protections to borrowers and lenders.

Foreclosure and eviction is the legal backbone of the loan recovery process. The ability to recover loans in default is based largely on the effectiveness of foreclosure procedures and the willingness to implement them. The key ingredients to effective foreclosure and eviction are clear and timely registration procedures and systems, the ability to pledge real property as collateral, clear and efficient execution procedures, the position of mortgage liens in the priority of debt, and the ability to evict borrowers who have defaulted on their loans.

Clear Registration Procedures

It is essential to have clear and rapid procedures for registration of title and mortgage liens. Mandatory registration promotes use of the public record as a reliable source of information on the status of encumbrances on the property. It allows lenders to assess whether making a loan is overly risky because there are too many liens on the property or there are problematic title issues.

Title and lien registration is currently one impediment to the development of reliable loan recovery across CET countries. Registration systems are both in flux and overloaded with the transition to market economies. The issue of restitution, including all types of property such as nationalized housing, commercial operations, and urban and agricultural land, has tied up court systems in many countries as the courts sort out large numbers of restitution claims, many of which are filed under deadlines stipulated under the law. Housing privatization is still ongoing or coming to a close in most CET countries, producing tens or even hundreds of thousands of new registration entries annually in countries such as Hungary, Slovakia, and Poland. Legal and economic reforms in the housing sector have resulted in a veritable boom in real estate transactions, as privatized housing units and other properties change hands at a pace unseen in the socialist era.

Court systems are operating with a sometimes severe lack of capacity to deal with the huge influx of registrations. They suffer from a lack of trained judges and a socialist era prejudice hindering the maintenance of meticulous and reliable records on private property, resulting in substantial delays in court decisions. Property registration can take six months or more, causing many uncertainties during the transfer of ownership. Given the lags in registration time, coupled with the frequent lack of clarity and recent change in lien priorities in many countries, (see discussion on Priority of Liens, below) lenders rightfully proceed with caution in this area, although it does not appear to be a deciding factor when underwriting a loan.

Most of the countries in the region have passed legislation governing restitution, which typically lets claims expire after a limited period of time. The number of cases should decline, easing this load on the courts somewhat. Housing privatization is coming to a close across the region, and when it is completed, the burden will decline further. In addition, countries like Poland and Hungary are committing substantial resources to revamping property and lien registries with state-of-the-art computerized systems, sometimes with donor assistance, which should improve the effectiveness and timeliness of registration systems significantly, but not for several years.

Real Property as Collateral

One of the most basic provisions necessary for foreclosure is the right to use the property that is the subject of the loan as collateral. For most borrowers their home is their only asset valuable enough to serve as collateral for the full amount of the outstanding housing loan. In most market economies it is standard lending practice for the property which is the subject of the mortgage loan to be used as collateral for the loan. If the sale proceeds are insufficient to cover the balance of the outstanding loan after sale of the seized property, lenders may be allowed to pursue a deficiency judgment against the borrower and seize other assets of the borrower to satisfy the remaining balance.

During the socialist era, pledging real property as collateral was generally legally possible, but rarely relied upon as loan security. Thus, with the exception of only a few countries, passage of mortgage legislation per se is not required. As discussed earlier, other tools such as wage garnishment, third-party guarantors and other assets were used to secure loans, even though on paper the property also acted as collateral. This has remained the case throughout the region, despite the strengthening of enforcement and execution procedures in many countries.

In Hungary, until recently the debtor's real property could be seized and sold only after personal property.[4] However, 1996 changes to the Civil Code introduced the concept of an "independent mortgage" which permits the parties to agree in the loan contract that only the real property securing the mortgage is subject to foreclosure, without access to the borrower's other assets.[5] In Slovakia and Croatia, recent legislative changes allow personal property to be seized only in the event of a deficiency judgment in which the real property is worth less than the outstanding loan. These changes are indicative of the increasingly permitted legal use of real property as collateral in many countries across the region.

Clear and Efficient Execution Procedures

A reliable loan recovery system requires a legal framework that clearly describes the process required to obtain a right to foreclosure and the process for executing the foreclosure. Procedures to be described include who has the authority to set and collect fees that may be charged and the priority of payments from the proceeds of execution.

Foreclosure is usually carried out in one of two ways, either through a judicial or non-judicial procedure. Although details vary, generally the process of judicial foreclosure in CET countries is on paper similar to the process in western Europe or the U.S. It begins with a trial to allow both parties to present their positions. If the lender wins, a court order is granted to foreclose. An independent appraisal and title search are performed on the property to make sure there are no title problems and to set a minimum bid for auction.[6] Notice of the auction is sent to all interested parties and the public, followed by the auction sale and judicial confirmation of the sale to ensure that the sales price was reasonable. Both the lender and the borrower are generally allowed to bid at auction. Proceeds from the sale of a foreclosure are used to pay the expenses associated with the auction, the lender, other lienholders, and finally, to the extent there is a surplus, to the borrower. The law may provide that the lender has the right to pursue a deficiency judgment against the borrower in the event the sale proceeds are insufficient to cover the outstanding debt.

Historically, foreclosure in CET countries has been possible only after undergoing lengthy court procedures which equal or exceed some of the slowest procedures in western Europe.[7] Periods of two years or longer have often been required to reach a final foreclosure judgment which allows the property to be sold. In many cases, the lengthy procedures are the result of a court system which has allowed the defaulter to challenge court rulings throughout the judicial process, thereby delaying as long as possible the final decision. Why did the systems develop in this way? Cultural and political factors can explain heavy protections for borrowers and lack of concern with maintaining the economic viability of housing lenders on market terms.

Non-judicial foreclosure shares many of the characteristics of judicial foreclosure, such as appraisal, notice to interested parties and the public, and auction sale; but it allows lenders to initiate sale of the property without going through the expensive and lengthy process of a court trial. This is an area where significant change has occurred in CET countries over the last few years. In Hungary, Poland, Croatia, and Slovakia, for example, changes in the legal framework have been realized which on paper allow for relatively swift and effective non-judicial foreclosure procedures, in addition to the judicial procedures described above. In some countries this is a result of completely new laws governing execution and enforcement; in others it is a result of multiple smaller changes to the legal framework over a longer time period. The result, however, is that the legal environment in these countries is more or less on a par with the U.S., which is widely considered to have stronger laws in this regard than most of western Europe.

In CET countries, non-judicial foreclosure is permitted if certain conditions are included in the loan documents. Typically, non-judicial foreclosure may occur if the parties consent to this method in the loan agreement and if conditions for foreclosure are met. In Croatia, the ownership of the property is put in trust until the loan is repaid. In the event of default, the property can be taken over immediately by the creditor without going through the courts. In Hungary, the Law on Execution stipulates that if the loan agreement is prepared by a public notary, foreclosure procedures may begin without a court order.[8] If the borrower wishes to challenge the foreclosure, the onus is generally on him to initiate the necessary court action. One factor impeding more widespread use of this method is that the fees for notarization are quite high.

Priority of Liens

Another important execution issue is the order in which debts are satisfied with the proceeds from sale of the property. Rules for determining lien priority are necessary for lienholders to know where they stand in line to collect in the event the borrower defaults on a debt, and a lienholder seeks to foreclose and sell the property. It is a widely recognized problem that mortgage liens are in a low position in the subordination of debt. In Poland, which has perhaps the weakest situation, a lender's security interest may be realized only after a number of other debts are satisfied. The order is: execution costs, alimony, labor and other employee dues, taxes, and fees for perpetual usufruct of State Treasury or local government (gmina) land and buildings.[9] The priority of tax liens is a particular problem in Poland, because these liens need never be registered or otherwise disclosed until a foreclosure is underway, making it impossible for the lender to assess the risk that unpaid taxes will exceed the value of the secured property.

In Hungary, the order of debts to be satisfied is child support, other support, wage garnishments, court-mandated payments which are the result of criminal litigation, public dues (including taxes), and other claims, in which mortgage liens are categorized.[10] Furthermore, within the "other claims" category there is a lack of clarity in the lien priority, causing further uncertainty when securing a mortgage loan. In Slovakia, the recent Law on Court Executors and Enforcement Activities places mortgage liens in a relatively higher position; after only execution costs and taxes, liens of a preferential nature are satisfied.

It is standard practice in the U.S. and western Europe for taxes to occupy the top lien priority. However, permitting four or five categories of debt to occupy a lien priority superior to the mortgage increases the lender's risk of not realizing full loan recovery and is a definite disincentive to lending. Fortunately, most CET countries are considering raising the priority of mortgage liens.

Ability to Evict Borrower

From a lender's perspective there is little value in a property that can be foreclosed upon but not resold to another party free of inhabitants. An occupied property will depress the sales price at auction because the new owner will be forced to contend with the expense and trouble of evicting the borrower still in residence. Lenders are generally not interested in purchasing the property only to be a landlord to the borrower who remains in residence as a tenant.

Legally, the foreclosure of the mortgage loan means only that the borrower's ownership of the property and right to redeem the loan are terminated. Eviction of the borrower is a separate legal process. The law may offer several alternatives. The law may provide that a court order sanctioning the foreclosure is sufficient grounds for the lender to obtain an order to evict. In other cases the order to foreclose and the order to evict are issued at the same time. The third scenario, and the most cumbersome process for the lender, is to pursue a separate legal action against the borrower-resident who refuses to vacate the property after a foreclosure order is issued.

In many CET countries, even where the legal basis for foreclosure existed, the law excepted certain groups or mandated that the lender provide alternative housing to the evicted parties. The provision of alternative or "substitute" housing, which implied a unit comparable to the one being vacated, is now no longer required, although the conditions vary somewhat. In the Czech Republic, for example, the law now states that the lender must provide "shelter," a much more flexible requirement than the provision of alternative housing. According to the Execution Law in Hungary, the bank has no responsibility to provide alternative housing, although there exists a perceived need or duty for the banks to be socially responsible and provide some sort of acceptable alternative. In Slovakia and Croatia, provision of alternative housing is not mandated in the new legislation in the event of eviction, but it is still required in the public rental sector.

For social and legal reasons, however, eviction is still not usually pursued. The concept of eviction is still widely regarded as foreign, and many people do not understand the legal process since it has so rarely been used. In the Czech Republic, there is no requirement that the foreclosed property be vacant at the time of auction. The Hungarian Civil Code instructs the occupant to deliver the premises vacant in the event of foreclosure.[11] However, the Execution Law does not provide clear or practical guidelines for how this procedure will be carried out if the occupant fails to obey the law. In contrast, the new Croatian law does provide clear but untested procedures for eviction.

It is important to emphasize that in CET countries where the legal framework has been strengthened, there is still very little implementation experience, especially with residential evictions. It is difficult, therefore, to measure the effectiveness of these procedures. Moreover, the recent improvements do not usually apply to loans made before changes to or passage of the applicable laws. Also, although all countries seem to be moving in the same direction, the strength of the legal framework varies among them. In general, it appears that eviction will be the last practical barrier to perfecting the effective use of housing as collateral.

CONCLUSION

The outlook for housing loan recovery in the Central Europe Transition countries is certainly much brighter than it was only a year or two ago. Significant legal and procedural reforms have been implemented recently. Lenders across the region now have at their disposal more and stronger loan recovery tools than at any time in recent history. Nonetheless, the region has yet to see the advent of true mortgage lending, where the primary security of the loan is the property being purchased. This will require a "leap of faith" on the part of lenders, who must begin to simplify and ease underwriting criteria if they hope to attract larger numbers of borrowers and make loans more affordable.

In addition, in most countries there are still a number of secondary legal issues that remain to be resolved, such as the administration and implementation of the mortgage system, forced sale and eviction procedures, priority of payment after execution, and other areas such as mortgage insurance, credit bureaus, etc., which still can be considered part of the legal system.

The good news is that governments and financial institutions appear to have come to the conclusion that if a healthy and responsive housing finance sector is to develop, banks cannot be held financially responsible for the social welfare of their clients who may default. Continued support for strong loan recovery over time is one of the crucial ingredients to making housing finance, and thus housing itself, more affordable. This will require a large amount of communication and cooperation among all players in the system. The focus is now shifting to implementing the new systems which balance the needs of the banks, borrowers, courts and politicians.

In some countries, this means publicizing the new regulations and disseminating information about their applications to lenders and the general public. Even many lenders are unfamiliar with the implications of the legal changes. Implementation will be a process which will involve testing new social and legal standards allowing foreclosure and eviction. Some real cases need to be brought before the courts to establish limits and precedents for foreclosure and eviction proceedings; and, just as important, to act as real deterrents to non-payment and spur the strengthening of the credit culture. This may require banks to undergo some negative press coverage or bad publicity, but it is a necessary evil to show that foreclosure is a reality.

Some aspects peculiar to the CET region will produce difficulties in reaching the level of reliability of loan recovery and the sophistication of delinquency and default prevention tools found in the U.S. and western Europe. The development of credit bureaus, for instance, are handicapped by a premium placed on privacy of information across the region, a testimonial to the extensive invasion of privacy perpetrated under the previous political regimes. Cultural and social differences with the U.S., as in western Europe,

Figure 1. Summary of Current Loan Recovery Framework in CET Countries vs. the U.S. and Western Europe[12]

Description	*PO*	*CZ*	*SK*	*HU*	*CR*	*WE*	*US*
Security of loan without third-party guarantors (in practice)	✘	✘	✘	✘	✘	✔	✔
Use of high loan-to-value ratios (more than 75%)	✘	✘	✘	✘	✘	✔	✔
Efficient registration procedures	✘	✔	✔	✔	✘	✔	✔
Use of real property as collateral	✔	✔	✔	✔	✔	✔	✔
Non-judicial foreclosure available	✔	✔	✔	✔	✔	✔	✔
Clear and efficient enforcement procedures	✘	✔	✔	✔	✔	Mixed	✔
Clear priority of liens	✘	✘	✔	✘	✔	✔	✔
Adequate position of mortgage liens in priority of debt	✘	✘	✔	✘	?	✔	✔
Ability to evict defaulting borrower	✔	✔	✔	✔	✔	✔	✔
No substitute housing requirement	✔	✘	✔	✔	✔	✔	✔

will likely mean that foreclosure and eviction will not be pursued with the vigor and success that it is in the U.S. It appears to be likely, however, that all the ingredients necessary to the operation of a fully functional loan recovery system will soon be present in most CET countries.

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NOTES

[1] These countries include, roughly from north to south, Poland, the Czech Republic, Slovakia, Hungary, Slovenia and Croatia. One reason to group these countries together is their shared history of at least partial inclusion in the Austro-Hungarian Empire and its historical influence on the legal framework for mortgage lending and housing loan recovery. This paper includes information and data gathered by the authors as a result of working contacts in all of these countries with the exception of Slovenia.

[2] "Moral hazard" refers to the incentive to "cheat" in some way that arises when the costs of such cheating are borne by a third party while the benefits accrue to the cheater. Insurance encourages lenders to originate and service loans less carefully, because they do not have to bear the full consequences. This is sometimes reduced by some sharing of the losses; nevertheless, the costs of offering insurance coverage will be somewhat inflated by this problem.

[3] The low foreclosure rates could also be affected by large loan write-offs.

[4] Act LIII of 1994 on Execution by Court art. 7(2) [hereinafter Hungarian Execution Law].

[5] Hungarian Civil Code art. 269 (1996).

[6] Sometimes the method of determining the minimum bid is stipulated in the relevant legislation.

[7] For example, the typical foreclosure process in France, one of the countries with the lengthiest procedures, can last between 18 and 24 months. In Italy it is even longer, with the process lasting anywhere from three to five years.

[8] Hungarian Civil Code art. 260(1).

[9] Civil Proceedings Code, art. 1025.

[10] Execution Law, supra note 1, art. 165.

[11] Hungarian Civil Code art. 48.

[12] Denotes western Europe in the sense that most countries in that region are in agreement with the described statement.