

## Country Paper - Housing Finance - Estonia

### I. Macroeconomic developments<sup>1</sup>

*Following the abrupt slowdown in economic activity in 1999, caused by the Russian crisis, the recovery in Estonia resumed momentum in 2000-01. Growth, driven by strong investment—financed through strong FDI flows—private consumption and net exports, and supported by a solid productivity performance and sound macroeconomic policies, averaged 5.2% over 1997-2001. Such a strong performance in the midst of an economic slowdown in the EU and the United States during 2000-01 is noteworthy. Nonetheless, significant growth fluctuations, from almost 10% in 1997 to a negative 0.6% in 1999, led to sizeable swings in the government budget deficit and the current account. The general government balance averaged –0.5% of GDP in 1997-2001, but reached a deficit of 4% of GDP in 1999 as a result of the weak economic activity that year. Similarly, although the current account remained in deficit over the same period (-7.8% over 1997-2001), the large fluctuations in growth led to considerable variability in the external, particularly the trade, balance. Inflation, which had been moderately high in 1997, at some 9%, followed a downward trend until 1999, but edged up subsequently at 5.6% in 2001. Throughout this period Estonia maintained successfully a currency board arrangement and the real effective exchange rate, which had appreciated considerably in 1998 during the Russian crisis, remained relatively stable since 1999.*

*Structural reforms have continued at a strong pace, although progress has been uneven. The privatisation of public enterprises has been largely completed and there are no significant barriers to entry into markets for either domestic or foreign enterprises. The reform of the pension system has advanced considerably with the implementation of the 2<sup>nd</sup> pillar, which is envisaged to be completed during 2002, and an independent Financial Supervision Authority was established at the beginning of 2002. Nevertheless, progress has been rather slow in land reform, and the reform of the health system, while plans for privatisation in the energy sector have been cancelled.*

*In spite of the vigorous economic upturn in the EU during 1997-2000, and the strong negative impact of the Russian crisis on GDP growth in Estonia, convergence to EU per capita income levels has been significant. The average per capita income in purchasing power standards reached 42.3% of the EU average in 2001. This reflects good progress made in catching up to EU income levels. Nonetheless, in spite of the small size of the country, regional divergences remain acute, with per capita income in the Northeast and South of the country just below 40% of income in the North. Employment creation has also been lacklustre in some parts of the country reflecting, in part, the regional divergences in growth. Consequently, while the unemployment rate has declined, especially since 2000, regional and age differences remain sizeable; the average unemployment rate ranged from 17.5% in the Northeast to 10% in the Western part of the country, while the youth unemployment rate (i.e., for those between 15-24 years), of some 20%, was almost double the unemployment rate for the rest of the labour force. On the other hand, the female unemployment rate, which averaged 10.6%, was only slightly below the average male unemployment rate of 12.3%. The employment rate, of about 63% during 1997-2001, followed a similar pattern, edging down throughout the period but increasing somewhat in 2001.*

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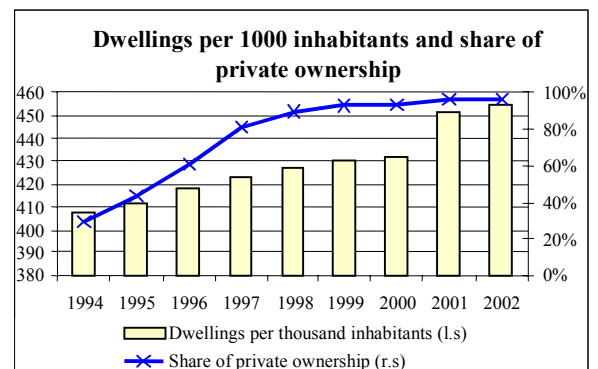
<sup>1</sup> Source: 2002 REGULAR REPORT ON ESTONIA'S PROGRESS TOWARDS ACCESSION

Macroeconomic Characteristics						
Estonia	1 997	1 998	1 999	2 000	2 001	2002 latest
Population (thousands)	1 400	1 386	1 376	1 370	1 364	1 361
GDP						
- real growth rate (%)	9.8	4.6	-0.6	7.1	5.0	6.7
- gross in million of USD	4 468	5 484	4 905	5 186	5 458	6 447
- per capita values in USD	3 192	3 956	3 565	3 787	4 002	4 737
Gross savings ratio of GDP	17.7	18.4	18.4	22.8	23.4	23.2
Gross fixed capital formation of GDP	28.1	29.6	24.9	25.4	26.1	
Inflation (annual)	11.2	8.2	3.3	4.0	5.8	4.2
Wage (monthly average) in kroons	4 027	4 389	4 799	5 279	5 879	

## II. Housing Sector Overview

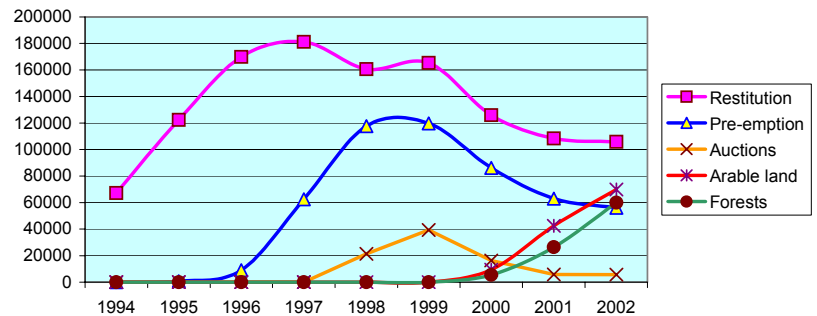
### Housing market

The privatisation of dwellings that had started in the early nineties changed considerably the structure of dwelling owners. The share of public dwelling stock has decreased from year to year and the share of private dwelling stock has grown. At the beginning of 1994, 71% of the total number of dwellings were in state or municipal ownership, as against only 4,2% at the beginning of 2002 (0,7% of dwelling stock was owned by the state and 3,5% by local governments). 95,8% of dwellings were in private ownership.

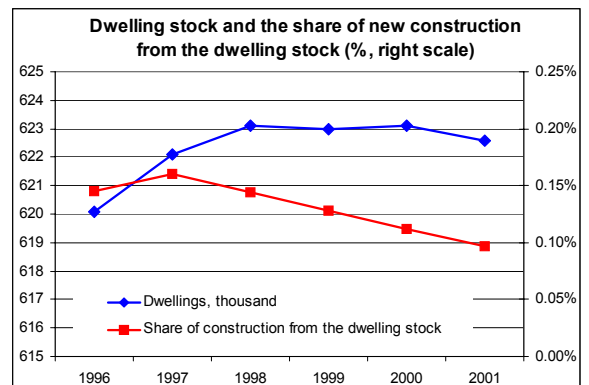


The land reform in Estonia includes restitution, privatisation and transfer of land into municipal or state ownership. Different sectors of the reform have started in different times and have progressed unevenly. Most sectors have overcome their culmination (see Chart) and are gradually dying down. Only the privatisation of arable and forested land free of restitution or pre-emption claims is still speeding up.

Annual increase of the area (in hectares) registered in the Land Cadastre (extrapolated values for 2002)



Real needs for housing construction and/or major renovation have been increasing over the time. Currently the construction of new dwellings does not compensate for the amortisation of dwelling stock. Due to the fact that the supply of real estate is not flexible and can increase only gradually in the short run, the property prices in suburbs tend to rise over the business cycle.



Preferences of households regarding their living places have not changed remarkably. Due to the low-income level the demand on flats in suburbs in Tallinn will remain the highest. One reason behind this is growing concentration of population in Tallinn –area. However,

because prices in suburbs have been risen relatively fast, new apartments have been become more attractive. Most of these apartments are sold before they are completed.

Because the economy is growing and the average salary is increasing, several developers have started new projects in the Tallinn City centre and in the suburbs. Prices start from 11,000 kroons (667 euros) per square meter in the suburbs and are as high as 35,000 kroons per square meter in old town.

According to the last coalition agreement some municipal houses have been already built and reconstructed in Tallinn. This was mainly triggered by the emerged situation accompanied by the privatisation processes. Namely, according to the non-official estimation there are circa 20 thousand households staying in returned floor-space (6000 houses) today.

### Sources of housing financing

In the early nineties people had the possibility to privatise their dwellings for the units of the Privatisation Fund provided by the government, whereas today new generation of young people acquires dwellings by borrowing. In spite of favourable loan conditions, the share of households preferring own funds for acquisition of property is relatively high (accounting for 40% by latest market research).

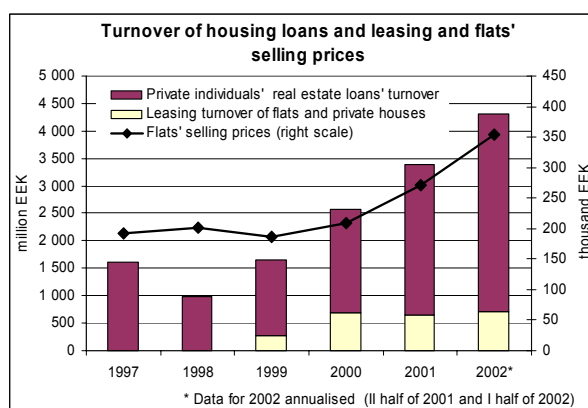
Statistical data on the housing sector						
Estonia	1997	1998	1999	2000	2001	2002 latest
Number of dwellings per 1000 inhabitants	442	447	452	454	452	454
Average surface per dwelling (square metres)					59.3*	59.4
Usable floor area of completed buildings (in thousands of square metres)	121.6	99.3	87.1	78.5		
Construction Price Index	100.0	107.7	109.9	112.6	119.0	
Detached house index	100.0	107.9	110.3	112.6	118.6	123.5
Apartment building index	100.0	107.6	110.3	112.5	119.2	124.7
Number of dwellings by type of ownership (thousands)						
A. Private dwelling stock	503.7	559.5	579.0	585.7	592.0	592.6
B. Public dwelling stock of state	15.4	11.8	6.6	5.3	4.0	4.0
C. Public dwelling stock of local government	103.0	51.8	37.4	32.1	21.9	21.9

\* Data based on the results of the 2000 Population and Housing census

## III. Mortgage Loan

### Recent developments and current features of the mortgage loan industry

Since 2001, the largest part of the real sector loan and leasing growth has been channelled to the real estate loans and leasing (commercial and housing loans). This situation has been enhanced by aggressive competitive activity on the banking market, which has specially pushed the supply of housing loans.



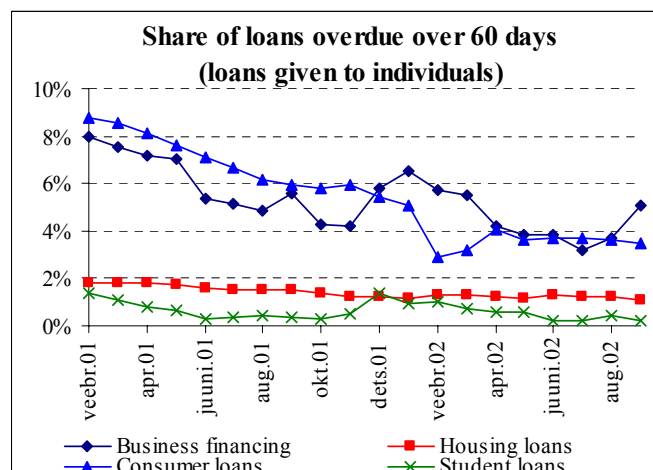
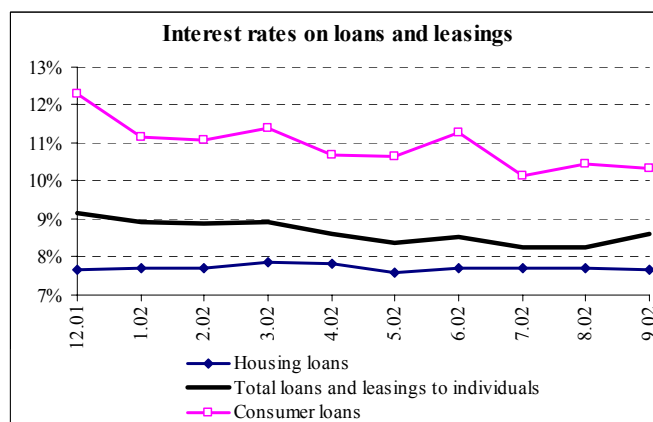
Strong growth of housing loans has been supported by **loosened loan conditions**.

- In spring this year, banks decreased the requirement for down payment in loan project up to 0% rate for some loan products (however, additional collateral was required) and continued to provide pretty good access on housing loans (e.g. application process via Internet, decision processes more facilitated etc).
- In addition, due to slow economic growth in Europe, which has kept the ECB from rising interest rates, domestic interest rates have been decreasing further in 2001 and 2002 (see Chart). Estonian banks have obtained their resources at a lower price due to the raised credit rating of the country and confidence in the economy.

Favourable loan conditions under sharpened competition of banking sector have resulted in the growth of housing loan and leasing portfolio by 2,7 bn EEK during first nine months of 2002 to the level of 9,9 bn EEK at the end of September, indicating a yearly growth of 50%.

**Loan quality** of housing loans has been relatively good. The share of non-performing loans in this segment has been relatively stable around 1,2% (see Chart).

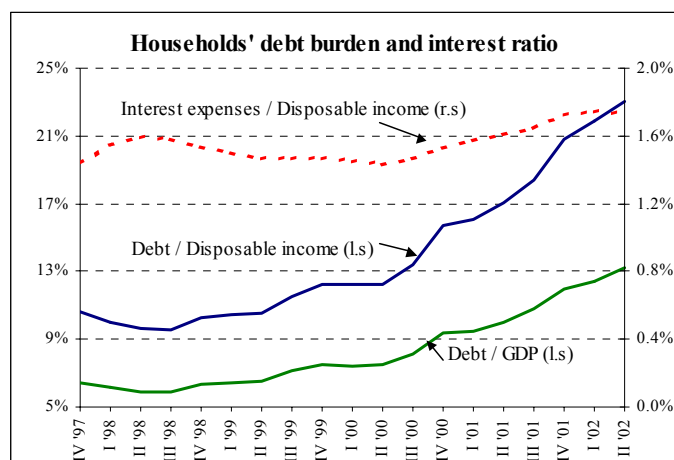
**Forms of housing loans.** In Estonia, the housing finance system is bank dominated. Share of leasing in this segment is relatively low accounting 16% of housing financing.



### Risks on financial sector

For Estonia, it could be marked that **banks are well capitalised and the quality of financial supervision has been improved remarkably**. But still, even if financial systems are well capitalised and properly supervised, financial fragility can still arise in the circumstances of excessive corporate and household debt.

**The debt burden of households** is not high compared to developed countries, reaching 14% of GDP at the end of III quarter of 2002. In addition, the latest census (2000) shows that only 12-13% of the households has taken up a loan to purchase a dwelling. Therefore, the acquirement of dwellings by borrowing or leasing is still not widespread among Estonians.



Thus, although the real estate related loan and leasing portfolio of households has been rising faster than disposable income; the **debt burden of**

**households** is not high compared to developed countries. Also, due to the low interest level, the debt burden has been well bearable so far (see Chart).

#### Most recent developments: central bank highlighted potential risks

As some signs still exist which can deteriorate expectations for sustainable economic growth, Bank of Estonia decided to give a clear warning signal to the public. In autumn 2002 the following measures were taken to decrease potential risks on financial sector stability resulting from expansive loan growth and rather moderate saving:

- Together with Ministry of Finance around 600 millions of kroons of government deposits have been taken out of commercial banks and transferred to Bank of Estonia;
- Together with Financial Supervision Authority proposals have been issued to make the loan conditions to private sector by commercial banks more severe.

Under forenamed proposals the central bank and the Financial Supervision Authority ordered commercial banks to keep an eye on lending risks. As regards housing financing following aspects should be mentioned:

- By allowing smaller down payment than (highly recommended) 1/3 of project value the additional collateral should be asked for in amount that exceeds together with other collateral 150% of loan amount granted. However, because of potential swings in real estate prices, the minimum own financing should be settled by 10%.
- By assessing the value of collateral it is recommended to consider price changes of respective collateral during last two years.
- Drawing up their lending policies, banks should pay more attention to factors such as economic cycles. More moderate growth of the loan portfolio would ensure that the number of bad loans remains under control even when the economy goes into a downturn.

#### **Recent developments regarding the legal framework for mortgage and the regulatory framework for mortgage lending**

##### Acts

Bankruptcy Act (1992)  
Law of Property Act (1993)  
Land Register Act (1993)  
Land Cadastre Act (1994)  
Credit Institutions Act (1999)  
Law of Obligations Act (2002)

Translations of aforementioned acts are available on the Web site of the Estonian Legal Translation Centre:  
<http://www.legaltext.ee>

##### Land and title registration

Estonia has the electronic land register - the register part of which is recorded on a data medium designated for that purpose and which can be permanently reproduced in an unaltered, legible form. The land registry journal prescribed for internal use in the land registry and to which access is not allowed is also electronically maintained. The Minister of Justice shall approve the procedure for maintenance of an electronic land registry journal. Land registries maintain electronic land registers

concerning their own land registry jurisdiction. The information of the register parts of all land registries is recorded and stored in one data processing centre with which land registries have a direct link and which is designated by the Minister of Justice. The data processing centre is neither the land registry nor maintains the land register but solely ensures the electronic recording, storage in a permanently unaltered state and reproduction of the information of the land register for land registries and entitled administrative agencies and persons.

According to the Land Register Act in the processing of a land register:

- 1) measures against loss of information shall be taken by making the necessary copies of databases at the end of each working day and by ensuring the storage of original information and copies as required;
- 2) making, amendment and deletion of entries only by competent persons shall be ensured, and access by incompetent persons to information shall be excluded;
- 3) the possibilities for smooth reproduction of land register information on screen and on printout shall be ensured;
- 4) all inquiries to the land register shall be recorded.

#### Issue for capital adequacy framework

The treatment of mortgage loans in respect of credit risk in **banks' capital adequacy framework** is different from the other loans one. In calculating the capital adequacy, the mortgage loans belong to 50%-weight risk category while other loans to individuals are dealt within 100%-weight risk category. However, the claim is considered a fully mortgage backed in case the amount of it does not exceed 2/3 of the value of the mortgage.

### Statistical data on the housing loan business

#### 1. Mortgage loans outstanding (in USD, % of GDP)

	mn USD	in% of GDP*
31.12.97	171.62	3.84%
31.12.98	352.79	6.43%
31.12.99	407.71	8.31%
31.12.00	510.29	9.84%
31.12.01	704.64	12.91%
30.09.02	1 066.78	16.29%

\* Annualised GDP for 2002 is estimated.

#### 2. Mortgage loans outstanding by borrowers (million USD)

	31.12.97	31.12.98	31.12.99	31.12.00	31.12.01	30.09.02
Households	29.52	55.10	88.57	128.63	214.58	363.66
Enterprises	137.84	286.64	302.04	359.26	471.92	667.67
Financial institutions	0.00	0.45	0.91	2.28	1.72	2.81
Non-profit and public sector	0.02	0.52	3.76	9.86	10.90	15.22
Non-residents	4.24	10.53	12.81	10.25	5.51	17.42
Total	171.62	353.24	408.09	510.29	704.64	1 066.78

### 3. Average terms of mortgage loans (interest rates, period etc)<sup>2</sup>

	1997	1998	1999	2000	2001	2002**
Weighted average interest rates of mortgage loans	11.9%	12.4%	11.0%	9.8%	8.8%	7.3%

#### Mortgage loans maturities by turnover (% of the total turnover of mortgage loans)

	1997	1998	1999	2000	2001	2002**
Up to 1 year	17%	19%	18%	14%	11%	9%
1 to 2 years	9%	2%	6%	4%	6%	4%
2 to 3 years	5%	6%	10%	3%	3%	2%
3 to 5 years	13%	10%	17%	13%	13%	8%
5 to 10 years	44%	54%	34%	44%	42%	43%
Over 10 years	12%	9%	14%	22%	24%	34%
Total	100%	100%	100%	100%	100%	100%

\*\* Data for the first 9 months of 2002.

### 4. Housing loans in the total assets of commercial banks

	31.12.97	31.12.98	31.12.99	31.12.00	31.12.01	30.09.02
Housing loans as % of total commercial banks' assets	5%	7%	7%	8%	9%	11%

## IV. Housing Finance Systems

**The Estonian financial intermediation is based on the universal banking model**, where the banking sector has a dominant role and the share of the securities market is relatively low. The Estonian banking market is a concentrated, mainly foreign owned (foreign ownership enfolds 85% from banks equity) and fully privatised market. Some specific features are stemming from (a) the small size of the country, (b) the short period of development, and (c) the status of Estonia as EU accession country.

Due to the strong parent banks (Swedish and Finnish origin) as well as remarkably improved credit ratings of "domestic" banks, there have been so far no difficulties to get foreign financing at low risk margin. Until the II quarter of year 2001 the growth of deposits was relatively strong, allowing banks rely on domestic resources. Current developments indicate that strong credit growth is financed more by foreign debt, which is also reflected by the widening of the current account deficit.

#### Alternative schemes

In addition to the classical housing loan products, one of the largest commercial banks has recently started to offer a product, which combines together, a housing loan and an endowment insurance contract (including life insurance). Under that, the borrower has monthly obligation to repay only interests of the loan and additional premiums of endowment insurance. The insurance company

<sup>2</sup> Coming from the currency board principles, the majority of housing and mortgage loans contracts comprise a covenant that relates the repayment of the loan with the exchange rate between Estonian kroon and the euro (before January 1999, DEM), shifting the potential currency risk to the borrower. Therefore, although these loans are originally issued and repaid in Estonian kroons, they are practically considered as loans issued in EUR.

will repay the principal amount of the loan in the end of the loan period, using the funds accumulated with the endowment insurance. The borrower basically has the possibility to earn additional income in case the profit of the insurance company exceeds a certain level, because additional profits will be distributed among customers.

#### Government policy on the development of housing finance systems

- **Tax advantages.** According to the Income Tax Act a resident natural person has the right to deduct, from the income which he or she receives during the period of taxation, interest payments made during a period of taxation to a resident credit or financial institution or a branch of a non-resident credit institution entered in the Estonian commercial register for a loan or finance lease taken in order to acquire a house or apartment for himself or herself or for his or her spouse, parents or children.
- **The Estonian Credit and Export Guarantee Fund KredEx.** KredEx is a self-sustaining fund in the jurisdiction of the Ministry of Economic Affairs and Communications, whose goal is to support the development of enterprises, exports and housing.

KredEx, which was founded in July 2000, provides various guarantees, which serve to improve the availability of capital for the SME-s, help to manage the export risks of enterprises and support the financing of home purchases and renovations by banks. KredEx acts on the principles of insurance and pursues the goal of creating a well-balanced and self-sustaining diversified portfolio.

In 2001, two new products were launched to complement the existing guarantee for young families – the loan guarantee for young specialists and for apartment associations. **The guarantee for young families** is designed for couples or single parents who raise a child of 16 years or less and who wish to purchase a new home or renovate the existing one. People who are up to 35 years old, with a higher or vocational secondary education and who have a valid employment contract can apply for the **young specialists' loan guarantee**.

In both cases, the guarantee helps to lower the applicant's self-financing rate to 10% instead of the usual 34%. The loan guarantees for young families and specialists were very successful – KredEx guaranteed 20% of the housing loans granted in 2001 by banks. By July 2002, already over 1600 young families and young specialists had used KredEx's housing loan guarantees when applying for a bank loan. In 2001, KredEx issued 2361 guarantees in total.

KredEx's **guarantee for apartment associations** makes a loan more available because now the association can take a bank loan without using the apartments as collateral. The guarantee covers up to 75% of the loan.

- **The draft of Mortgage Bond Act.** The Ministry of Finance prepared the first draft of a Mortgage Banking Act (German model) in the beginning of the nineties. In 1999 the Minister of Finance formed a working group to work out a contemporary mortgage credit model (secondary market mechanism) for Estonia and to set up a legal basis for that. This working group was divided into two subgroups: 1) mortgage banking model group; 2) special purpose investment fund model group. After its second reading in the Parliament the draft of Securities Market Act contained a new part on mortgage bonds (the adapted German model) but finally the act was adopted without the Part on Mortgage Bonds.

In 2002 the Minister of Finance formed a new working group with a goal to draft the Mortgage Finance Act (the name of the act is conventional). The result is the draft of the Mortgage Bond Act (MBA). The purpose of the MBA is to establish a legal framework for the issuance of

mortgage bonds and at the same time to fulfil the criteria of the UCITS directive article 22 (4). At the same time it would be the elimination of competitive disadvantage (stronger competition in Europe and the EU-enlargement will increase the need to access the cheapest, triple A rated funding). MBA is mainly based on the German model but has four very important differences: 1) authorised issuer is besides the special mortgage bank also universal bank; 2) there is no special supervisor (trustee); 3) if a bankruptcy proceeding has been instituted the payment is due for all mortgage bonds (no continuity of the cover asset pool until the last mortgage bond has been redeemed); 4) issuing of public sector bonds not regulated.

Due to the unfavourable situation for the processing of the draft of MBA it will be submitted to the government after elections next year.