The Performance of Mortgage Loans in Albania in Recent Years, Elements of the Process of Mortgage Lending in the Banking System and its Risks

MSc. Armanda Tola (Keqi)

Department of Banking and Finance, Epoka University, Albania

Abstract

Buying a home is one of the most important decisions and sometimes the biggest financial transaction that can be done in life. Mortgage lending is the primary mechanism used in many countries to finance private ownership of residential and commercial property. That in itself is a big deal since the interest that you pay is going to be a percentage of the amount that you borrow, so it is important to make sure that you are getting the best deal possible, since you are going to have it for a long time. At the same time as Richardson cited it's important that mortgage lenders have an incentive to internalize the deadweight costs associated with defaults and foreclosures. The development and expansion of the Albanian banking market in the recent years has created significant conditions to make a rational choice with the additions of new products and programs. This research will discuss the main steps of the procedure for obtaining a mortgage loan, the advantages and disadvantages of mortgages, the documentation required for obtaining mortgage loans, the credit risks and generally the performance of mortgage lending in Albania in the last 10 years, the prospect of mortgage loans and other main issues based on the appropriate literature review and secondary sources. Also as part of the topic is included a statistical study which analyzes the relationship between the performance of mortgage loans in Albania and other macroeconomic indicators as employment, inflation and the interest rate. The data was accessed from the official database system of INSTAT in the last 7 years and the elaborated results showed an explanation of the econometric model created. The conclusions provided in this case signified a strong relationship between the factors, indicating that the increase of the employment rate and of the deposit interest rate, as the decrease of the interest rate for loans and of the general level of prices are major factors that constrain the mortgage loans in Albania.

Keywords: Mortgage loans, Banking system, Risk, Albania, Employment, Interest rate.

What is mortgage?

The word mortgage is thought to have its origin from the old French mort-that means death and gage-which means pledge. If the borrower failed to pay the debt on the loan, the lender take the pledged property, turning it as a "dead" for the borrower. If the borrower pay the debt then the pledge would be considered dead for the lender.

The Civil Code of the Republic of Albania has this definition for the mortgages: "Mortgage is a real right that is putted on the property of the debtor or a third party, in favor of the creditor, to ensure the fulfillment of an obligation." This Code also defines , that mortgaged items are real assets, such as land, buildings and anything that is embodied steadily and continuously with the land or a building. When seeking mortgage loans for home purchases, apartments, offices, a shop, the customer can pledge his land, houses, apartment buildings, which we generally call real estates.

In terms of the law the owner is the person whose name is listed as the owner of the real estate. As for the origin of title acquisition for a real estate are recognized all property transfer contracts, court decisions, mortgages, deeds of inheritance, other legal documents that have effect on the rights to immovable property. If we take a loan for the purchase of a house or apartment, the property is registered in the name of the buyer, who also has to sign a mortgage contract, which is also registered in the relevant section of the real estate card used as collateral for the fulfillment of the obligation contractor, which is called mortgage burden.

The mortgagor / owner of the collateral in any case can not transfer the title of the ownership to a third person until the time that the borrower has fully repaid the loan to the Lender / Bank, which through a notarized declaration states agreed to the deletion of the mortgage or gives approval for the transfer of the title of the property, while maintaining "the mortgage burden".

The mortgage market is the market for financing real estate assets (Femi, 2013). It has been observed by Levine (1997) that provision of housing cannot be successful if a nation does not have a well developed mortgage market. Green and Wachter (2007) emphasize on the availability and of mortgages as crucial determinants in the functioning housing markets countries. Huybens and Smith (1998) argue that an increase in the rate of inflation could have at first negative consequences on financial sector performance through credit market frictions which entail the rationing of credit leading to reduction in intermediary activity as well as capital formation. Arcelus and Meltzer (1973) state that when markets rates of interest rise, and when expectations of higher inflation in the long run keep interest rates at the higher levels, it would not reduce housing demand permanently because after a time lag, wages and house prices would adjust to the higher anticipated inflation. Using regression analysis, Walley et al., (2013) found that inflation is negatively and significantly associated with mortgage market development. Warnock and Warnock (2008) among others have also measured the growth of the mortgage market in terms of the ratio of outstanding residential mortgage debt to GDP. They and Boleat, (2003) also argue that deeper mortgage markets are associated with a stable macroeconomic climate. Boleat (2003) argues that long term loans are not possible when inflation and interest rates are high and volatile and there must also be general economic stability. He argues that the optimal interest rate of borrowing would be at an interest rate of three to four percent above the cost of funds, but in most emerging markets the actual spread is five to eight percent and in developed countries it is under two percent.

The mortgage loan constituent elements

A mortgage loan consists of several elements, without which the loan would not be applicable. Each element must have a value, otherwise the loan can not be calculated. These elements are:

• The loan amount
• The interest rate
• Term loan
• The structure of depreciation
• The relevant dates of the loan payments
• Coins Credit

The loan amount only refers to the nominal value; in other words, the amount of money desired to be credited (the loan taken). Funding is the amount of money that can be taken from the property value. Usually banks put a minimum purchase price for the property. It often happens that the property valuations vary from 5% to 10% of the purchase price. Therefore, may be needed to deposit more money. Usually only the purchased property is offered as collateral.
The interest rate is the regular cost that the lender decides on the borrowed funds. This is usually expressed as a percentage of the loan amount, and calculated on an annual basis. It has an inevitable impact on the amount of the monthly installments. The deadline of the mortgage means the time it takes to repay the loan. This can be expressed in months or years. The term of the loan depends on age standard period is usually 20 years, but even though that is flexible and should fit solvency.

Advantages and disadvantages of mortgage

The main advantages of mortgage loans are as follows:

- By getting a mortgage loan, the borrower practices one of the basic principles of real estate acquisition: the purchase with the money of others. This eliminates the need to use money (cash) or stocks (deposits), which are so valuable in an emergency, or for other investment opportunities. Equally important is the fact that you can not possess the money to execute this transaction.
- With the purchase of a property can be avoided the rental costs. Also, the real estate can be used as a collateral for a second loan in the future.
- Mortgage Loan can serve to achieve different goals: building a summer house, renovating home, etc.
- The real estate can be used as a second residency or can give the rental income those which can repay the loan installments.

  However, in obtaining a mortgage loan there are also disadvantages and risks:
- There is a risk of default over time as a result of unemployment, illness, or any unpredictable event which is not covered by insurance policies consequently, the price of the home can result in less than the debt.
- The interest rate can fluctuate because the loans are granted with variable interest rates.
- The costs of a home loan usually vary depending on the bank, but obviously that costs are one of the issues that the customer should look carefully in order to make the right choice in a loan application for home. These costs include:

  - ✓ Administrative Expense
  - ✓ Notary costs
  - ✓ The life insurance policy
  - ✓ The property insurance policy by the earthquake and fire
  - ✓ The payment of evaluation of the real estate
  - ✓ The mortgage expenses for the blocking of the property
  - ✓ The monthly expense for the account maintenance
  - ✓ The penalty fee

Among the other disadvantages are that the payment of property assessment of the guarantee of the object is always paid by the customer. Also if the interest grows, the monthly payment of the loan will increase. Banks in order to fulfill their criteria for security, will try to know everything about you.

Risks of credit and how to protect

Risk is the event that can lead to unexpected losses. Some of the main risks which may be covered by the loan are the risk of damage of property purchased with mortgage loans and the risk of default as a result of loss of life. In order to reduce uncertainty, the banks cooperate with the insurance companies, the insurance policies required by banks that are operating in Albania are as follows:

1. Property insurance

Property insurance is a product that protects lenders against loss or damage of property offered as collateral. Property insurance is compulsory under the mortgage contract. Property insurance required by some banks will cover at any time at least the outstanding balance and the accrued interest. This means that while the loan is amortized the sum that is insured will be reduced. Therefore it is recommended to purchase insurance policies that at least cover the replacement value of the object insured. While property insurance needs to provide assurance to lenders and they are the first to benefit from property insurance. Currently, property insurance covers two basic groups of accident risks. These are the risks associated with fire (fire, gas explosion, lightning) and earthquakes.

2. Life insurance

Life insurance for the protection of the mortgage is simply a loan that pays the mortgage if the mortgage loan is not fully repaid in case of death. The insurance if the mortgage it’s not only provided for the benefit of the bank. Even though is a way to protect them from financial difficulties since it is not possible to predict what will happen to the borrower in 10 to 20 years (mortgages usually deal for long terms). If the borrower dies before repaying the mortgage loan, the lender must give to the borrower the right of property, to exclude his offspring, to sell the property etc. During the period of repayment of the loan the lender may face difficult situations, such as the acquisition of untimely salary, termination of employment, divorce or any unfavorable event, which would become an obstacle to fulfill the obligations to the lenders. In such situations, it is best to apply immediately to restructure the loan (generally this action is free of charges).

The main steps of the procedure for obtaining a mortgage loan

1. *Pre-Application* – The loan officer assists the applicant with the original terms of the loan for the house, explaining also all the costs for home loans. He provides the applicant with the set of documents and prepare the applicant with an amortization table loan example.
2. *Application of the loan* - the loan applicant fills out the form and submit the documents required by the loan officer (giving the consent to the loan officer to have the possibility of verifying the documents submitted).
3. *Verification of documents* – the loan officer, after receiving all the documents submitted, is responsible for carrying out the verification of incomes and the employment history, collateral, the credit history (if any) and the legal control of property documents. It will be used as a security for this loan. Then he finishes the financial analysis and prepare recommendations to the Credit Committee.
4. *The decision of the credit committee* - the loan officer sends the file of credit in the Bank Credit Committee for consideration. The committee after reviewing the recommendations made by the loan officer makes a decision to approve or not the loan as well as indicates the respective conditions.
5. *Notification of the decision of the loan applicant* -If the loan is approved, the loan officer informs the applicant about the approval of the loan, the conditions of the approval and informs him about the necessary documentation to be submitted for the second phase.
6. *The opening of a bank account* – This account shall serve for loan payments.
7. *The registration contract* - filed by the Office of Registration of Immovable Property serves for setting the property on behalf of the bank. When all the necessary documents are prepared, the bank is ready to disburse the loan in the account of the seller or the customer's account in case of loan for reconstruction or refurbishment.
8. *The disbursement and the documents* – After the disbursement of the loan, the client receives the original copies of contracts (loan contract, the contract of mortgage guarantee etc.), the original copies of insurance policies (life and property), copy credit costs and the detailed depreciation final table.

The performance of mortgage lending in recent years Albania

In the year 2007 the loans to individuals (In million EURO) reached the amount of 513.3852.5. The loan as the most important indicator of the economy, reached a record level of EUR 2.4 billion, thus reaching 30 percent of GDP. Within this indicator was recorded a significant increase of foreign individuals loans, which were raised by 66 percent, compared with the year

2006. The total achievement was more than 35 percent of the total loan portfolio of the banking system itself.

In 2008 the most important indicator of the economy, the loan, failed again to a record level, exceeding the limit of 3 billion EURO, by exactly 3.2 billion EURO, or 37 percent of GDP. An important development in this regard was to increase the balance of loans to the businesses and those for individuals, which rose by more than 32 percent each. The year 2008 was the first full year of operations of the Loans Registry, helping banks in making more objective decisions, avoiding problematic customers.

In 2009 the lending activity was about 51 percent of the system assets in December of 2009. Despite the significant slowdown during the year 2009, especially during the second quarter, the loans provided by the banking system rose by 13.4 percent compared with those in 2008, reaching the amount of 39.3 percent of GDP. Also, banks have increased continued lending in local currency.

In 2010 the lending reached about 49 percent of system assets in December 2010, an increase of 9 percent over the previous year. The moderate increase was due to the low demand for credit by economic agents, but also to prudent lending policies of the banks, which paid more attention to the quality of their loan portfolio. The lending mainly supported investments in the services and industry sectors, while the growth of consumer lending had an average growth. The new loans granted by banks in 2010 reached about 19 percent more than the loans issued during 2009. The maturity structure of the new loans indicated that banks are too more focused on short-term lending. In fact, short-term loans accounted for about 60 percent of new loans in 2010, reflecting the need of the economy for liquidity after the global financial crisis. Non-performing loans continued to rise during 2010, culminating in November 2010 to 14.4 percent of total loans, and decreased by the end of December to 14 percent. In fact, the loan quality indicators declined compared with a year ago as a result of a higher rate of growth of total loans. However, the credit risk remains the main risk for the banking system, reflected in large reserve funds created to cover potential losses. At the end of the year 2010 the provisions for the risk in lending were about 33 percent higher that at the end of 2009.

In 2011 Albanian economy was one of the few economies in southeastern Europe which experienced no decline despite the global crisis and its spread to Europe. In fact, the crisis proved that the banking system in Albania, as in some other countries of Central and Eastern Europe, has had a stabilizing character and not that of an accelerator, as was expected at the initial stages of the crisis. However, weak domestic demand and a slowdown in the external situation failed its growth prospects. The loan portfolio of banks in 2011 rose by 15.3 per cent, with an upward trend during the quarter. The level of non-performing loans amounted to 18.8 percent in December 2011, influenced not only by the difficulties in some sectors of the economy, but also by the slower credit growth rates in the last 2-3 years. As a result of the increased non-performing loans, and in accordance with the regulatory requirements of the Bank of Albania, banks increased their provisioning, which significantly affected the net result of the banking activity and the profitability indicators of the system.

The lending slowed in 2012, particularly in the second half of the year. At the end of the year, the annual growth was 2%, it decreased by 15.3% from the previous year, 2011. This performance reflects the slowdown in the overall lending growth and the low lending demand as a result of a high perceived uncertainty and a low business confidence in the future macroeconomic developments. Nonperforming loans have risen significantly over the past two years and reached a peak of 22.5% at the end of December 2012, from 18.8% in 2011. The main reasons for this increase were: the economic slowdown and the lack of the efficient execution procedures of collateral which hamper the recovery of assets pledged as collateral. In the year 2014 the Bank of Albania has confirmed that the added value in the construction sector has been able to record an annual growth of 16% in the second quarter. But surveyed data signaled a slowdown for the sector's performance potential of construction activity in the third quarter. Yet by the entering of new taxes on housing, the housing price index recorded a negative annual change in the third quarter of 2013, for the fifth consecutive quarter. The decline in real terms by 1.2% can be considered low compared with double-digit decline recorded since the third quarter of 2012. Bank of Albania has confirmed that the added value in the construction sector has been able to record an annual growth of 16% but surveyed data signaled a slowdown for the sector's performance potential of construction activity in the third quarter. The construction contribution to the annual growth of GDP is estimated at 1.4 percentage points and the realization of housing construction is estimated low, influenced by the low level of domestic demand, as well as the conditions of tight funding. As confirmed by the builders, new investments are diminishing, at a time when many companies suffer from uncollected payments and large debts. Loans from banks to purchase real estates to individuals amounted to 101.8 million in the end of October 2013. Mortgages have significantly reduced pace since 2008, when the economic and financial crisis began with its effects in the economy.

Methodology

The methodology adapted is the multiple regression analysis from secondary data obtained mainly from the Bank of Albania and the Institute of Statistics in Albania from the year 2007, subdivided into three-monthly periods. The data was subjected to a normality test before correlation and regression analysis is based on the assumption that the data is normally distributed. Correlation analysis was carried out to determine if there's any association between the various independent variables and the dependent variable and if this relationship is significant. The Pearson Moment correlation was used for conducting the correlation analysis since the data was parametric data. The ranking varies between 0 and 1, where 0 denotes no relatedness between variables and 1 denotes a perfect relationship. If the score is less than 0.3 that it would mean that there exists a weak relationship between the variables, if there is between 0.3 and 0.7 that indicates a medium correlation between them, and above 0.7 means that the variables are strongly correlated. The multicollinearity test was necessary to ensure that the independent variables are not exhibited strong multicollinearity so that the regression model could be reliable. According to Belsley, a condition index less than 15 indicates no problem of multicollinearity.

Model Specification

The general regression equation when dealing with more than one independent variable can be expressed as follows:

$Y=A+ B_1X_1+B_2X_2+B_3X_3+B_4X_4+e$

Where by:

Y=the mortgage loans

A=Autonomous Variable

X_1= Average Inflation Rate

X_2=Average GDP Growth Rate

X_3=Index of construction cost

X_4= Unemployment Rate

e= stochastic variables

B_1= Coefficient of X_1

B_2= Coefficient of X_2

B_3= Coefficient of X_3

B_4= Coefficient of X_4

Note: the mortgage loans indicate the total volume of the mortgage loans every year, the inflation and the GDP per capita are reported by the Institute of Statistics, and so is the unemployment rate which is the proportion of the population that is not working in the formal sector.

Findings

Pearson correlation test was used to test any kind of correlation between mortgage loans and the other independent variables such as those mentioned before: the average inflation rate; the average GDP growth rate; the index of construction cost; the unemployment rate. The results are shown below in the table for the various economic variables and the total mortgage loans.

Table 1 *Pearson Correlation for macroeconomic variables*

	Mortgage Loans	Inflation	GDP per capita	Index of construction cost	Unemployment
Mortgage Loans	**1**	**-0.211**	**0.839**	**0.512**	**-0.322**
Inflation	**-0.211**	1	-0.254	-0.151	-0.237
GDP growth rate	**0.839**	-0.254	**1**	0.656	0.701
Index of construction cost	**0.512**	-0.151	0.656	**1**	-0.723
Unemployment	**-0.322**	-0.237	0.701	-0.723	**1**

As shown in the table there is a week relationship between inflation and mortgage loans, the relationship between unemployment and index of construction cost and mortgage loans is medium. Even though the relationship between GDP growth rate and mortgage loans seems to be strong, therefore they seem to be having the greatest association.

After the collinearity diagnostics for the macroeconomic variables, the variable GDP rate exhibited multicollinearity. The other objective of the study was to establish the influence of the multiple regression model created. The table below shows the summary of the total explanatory variables in the model and its fitness.

Table 2 *Model Fitness for the various macroeconomics variables*

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.89
R Square	0.895
Adjusted R Square	0.886
Standard Error	0.020749

This indicates that the variation in mortgage loans around its mean can be explained by the regress variables in a large extent, more precisely about 88,6% of the variation in mortgage loans can be explained by the independent variables.

Conclusion

This study found that the relationship between GDP growth rate and mortgage loans seems to be the most influential, therefore to be having the greatest correlation. Various cross sectional such as Boamah (2009), Bryx (2006), Chiquier et al. (2004), Jaffe and Renaud (1996), Butler et.al (2009), Warnock & Warnock (2008) and Boleat (2003), Huybens and Smith (1998) and IDB (2011) among others in their cross-sectional studies argue that the mortgage market grows in a stable macroeconomic environment. Also as Chiquer and Lea (2009), Merril (2006), Boamah (2009) and Warnock and Warnock (2012) claimed that an unstable macroeconomic environment poses a high risk to the lender. In the Albanian situation seems to be an increase of mortgage loans during the recent years, followed by a contraction in this process from the effects of the financial crisis. That brought that, partly under the influence of the strengthening of the regulatory framework in Europe and also impacted by the deterioration of credit quality and risk perceptions, banks have become more conservative in their lending policies. There has been a change in the currency of the loan, denominated in foreign currency to local currency. Banks, however, continue granting loans despite the fact that asset quality has deteriorated significantly. According to the bankers among the factors with the greatest impact on the downward side of household demand for loans were: the decline in the consumer confidence and the use of alternative sources of financing. Precisely are the individuals who are addressing less to the banks, because of the uncertainty of the economic crisis. Immigrants also have invested less than in previous years in the housing market.

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Annex

Periods	**T2’08**	**T3’08**	**T4’08**	**T1’09**	**T2’09**	**T3’09**	**T4’09**	**T1’10**	**T2’10**	**T3’10**	**T4’10**
Mortgage loans	7.1	25,3	-29.3	-53.1	-35.9	-26,5	-26.9	1.2	-17.8	-15,6	0.6
Unemployment rate	13	13	13	13.8	13.8	13.8	13.8	14.2	14.2	14.2	14.2

GDP change rate	2.5	5.4	1.05	1.89	3.07	-1.76	-3.15	6.82	3.5	1.42	1.37
Index of construction cost	0.8	0.4	0.1	-0.4	-0.1	-0.1	0.1	0.2	0.2	0.2	0,1
Inflation	3.1	2.45	4.5	1.4	2.7	1.8	2.4	4.36	3.4	3.43	3.06

Periods	**T1’11**	**T2’11**	**T3’11**	**T4’11**	**T1’12**	**T2’12**	**T3’12**	**T4’12**
Mortgage Loans	7.3	11.8	-4.1	-15.2	-30	-6.1	-14	-9
Unemployment rate	13.9	13.9	13.9	13.9	13.4	13.7	14.1	14.1
GDP change rate	2.65	-5.06	4.97	3.16	-1.6	0.75	1.44	1,13
Index of construction cost	0.2	-0.2	0.4	0.3	-0.2	0.4	0.4	-0.1
Inflation	3.86	4.06	3.16	2.53	1.06	1.9	2.7	2.43

Periods	**T1’13**	**T2’13**	**T3’13**	**T4’13**	**T1’14**	**T2’14**	**T3’14**	**T4’14**	**T1’15**
Mortgage Loans	-10.8	6,9	-11,7	-2,2	-8,7	1,2	-10	2.1	15.1
Unemployment Rate	14.8	16.4	17.2	17.1	18.6	17.7	17.4	18	17.3
GDP change rate	0.34	0.13	-3	3.7	-0.08	1.6	1.26	-0.63	0.15
Index of construction cost	0.4	0.2	-0.1	0.6	-0.5	0.3	0.1	0.2	0.4
Inflation	2.5	2.23	1.5	1.26	1.93	1.83	1.8	0.6	1.93

Notes:

1. The periods given in the tables are the quarter periods of the year, for example T1’11 represents the first period of the year 2011 (from January to April).
2. In the absence of the statistical data of the unemployment rate during the quarters of 2011, it was assumed the o annual rate of unemployment of 2011(published by INSTAT Albania), that was 13,9%.