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Mortgage Lending and Risk Management in Serbia

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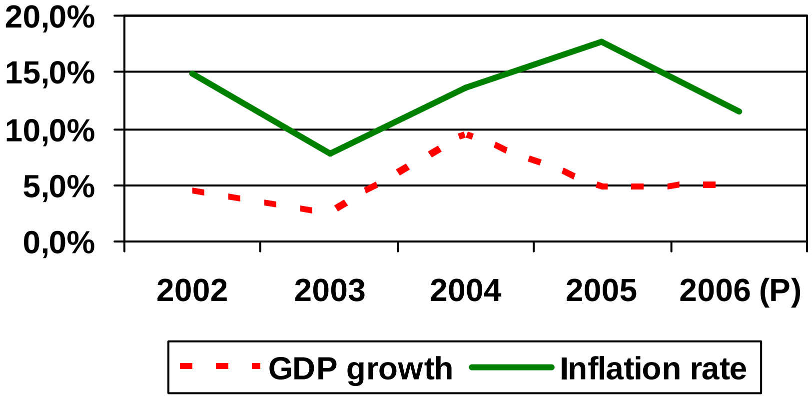
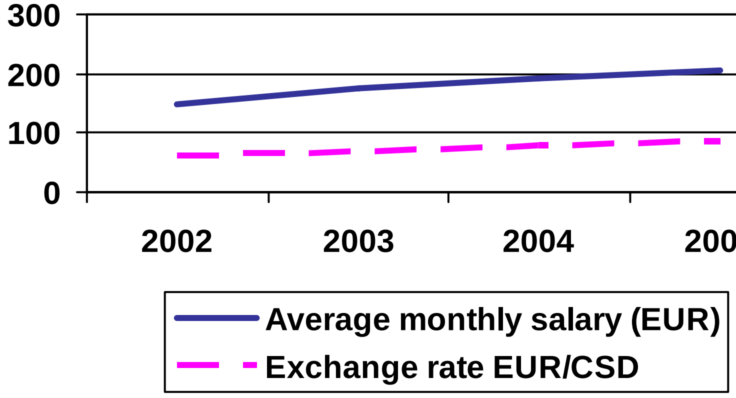
Serbia – main economic indicators





- In 2005, Growth was fuelled by exports. Outlook is positive
- Inflation was driven by consumer credit growth, VAT introduction and rise in energy prices
- Salaries are still growing albeit at a slower pace
- CSD depreciation reflects strong reliance on EURO of the Serbian economy

Serbia – main economic indicators

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	2002	2003	2004	2005	2006 (P)
GDP growth (%, y-o-y)	4.5	2.4	9.3	4.8	5.0
Inflation rate (%)	14.8	7.8	13.7	17.7	11.5
Unemployment rate (%)	n/a	31.9	32.4	32.6	n/a
Exchange rate EUR/CSD	60.71	68.3	78.9	85.5	87.5
Average monthly salary (EUR)	149	175	192	205	n/a

Source: National Bank of Serbia, IMF

P = projected

Banking sector in Serbia

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	2002	2003	2004	2005
Number of banks	50	47	45	41
Credit to households (% of GDP)	1.6	2.4	4.6	6.3
Deposits of households (% of GDP)	5.8	7.1	8.8	10.9
Liquid assets to total assets	25.7	20.0	21.0	15.1

Source: NBS, BA-CA, National Bank of Greece

- Banking sector is undergoing fundamental transition driven by foreign banks
- Foreign banks' share of total banking assets is 63% (Sept. 2005)
- Credit growth driven by high demand from low base and foreign banks' quest to gain market share
- Rapid credit growth may erode financial stability. Almost all lending is in EUR

Development of capital markets

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- Capital markets and money markets are small: no domestic corporate bond and paper markets, no secondary markets for treasury bills
- Development of underlying infrastructure (legislation) and governance is not yet really taken on.
- NBS has established a money market for short-term refinancing
- 10 banks established a “Belibor” market with a yield curve up to 6 months
- Government bonds are traded with approximately 300 basis points above German Bunds
- Insurance industry is quite small and underdeveloped (total assets to GDP amounted to 2% in 2004)

The housing sector in Serbia (I)

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Some data on housing in Serbia:

- Homeownership rate: 88.2% (as per 2004)
- Average household size: 3.3 (2003) down to 2.9 (2005)
- Housing prices to household income ratio: 16.6 (EU average: 7)
- House prices: large gap between metropolitan area of Belgrade and other cities and rural areas
- Rental construction is underdeveloped
  - Housing development under construction cannot be offered to lenders as collateral

The housing sector in Serbia (II)

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- Demand for housing:
  - Higher demand in urban areas (Belgrade, Novi Sad etc.) due to better employment perspectives and higher salaries
  - Real estate is considered a good investment
  - Broad expansion is hampered by low incomes (especially in countryside)
  - High demand for repair/renovation of existing housing stock
- Supply of housing:
  - New construction has not reached pre-war levels
  - Lack of housing and spatial planning policies
  - Lack of adequate regulatory framework

Primary mortgage market development

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- Mortgage lending started in 2003: with about EUR 40m (or 0.3% of GDP) it is one of the smallest market in the region
- Obstacles to market development
  - Low affordability and large size of informal economy
  - Large number of unregistered properties
  - Bumpy registration process of mortgages due to different real estate registration systems
  - Foreclosure is long and costly procedure
- Market is driven by foreign banks (Raiffeisen, Société Génerale, Hypo Alpe Adria Bank, HVB Bank, Procredit Bank)

Correlation between foreign banks' presence and mortgage loans

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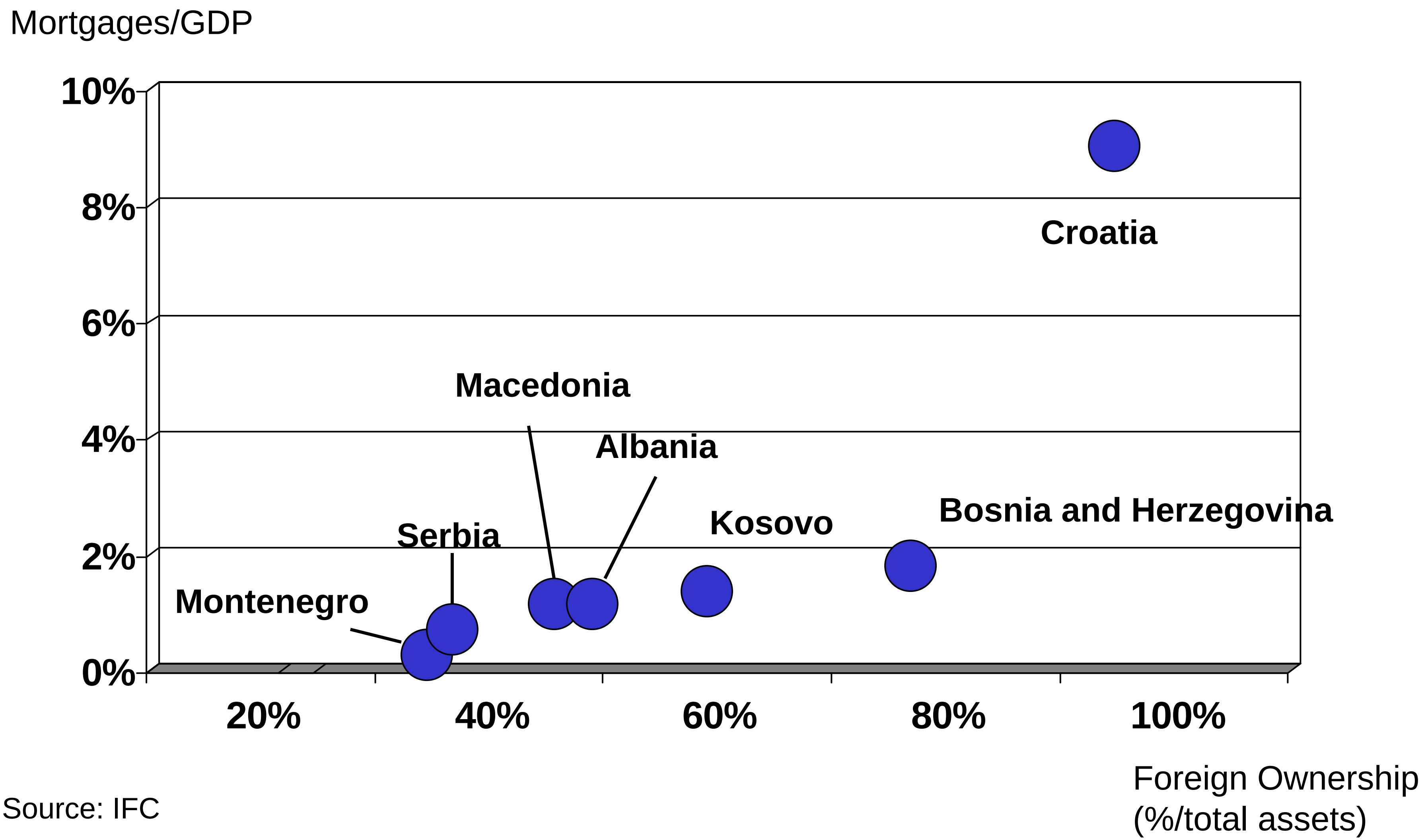

Source: IFC

Loan conditions and underwriting criteria

- Loan conditions:
  - Loan amount: min. EUR 10,000 up to EUR 200,000
  - Currency clause: CSD indexed to EUR
  - Term: up to 30 years
  - Interest rate: 7.95% to 10% (without insurance by National Insurance Corporation and government subsidies)
  - Down-payment: 20 %

- Underwriting criteria
  - LTV ratio: 70 - 80%
  - Collateral: mortgage and 1 to 2 guarantors, promissory note, salary barring
  - PTI ratio: 30 % (some banks accept higher PTI ratio)
  - Most banks assess creditworthiness on official income
  - Insurance: most banks require property insurance
  - Fees: up to 2 % of loan amount

Support functions for the primary market

- Credit bureau: every loan must be reported (loan size, term etc.)
- Appraisal: standards are missing. Banks often rely on defined value in property tax statement
- Mortgage Guarantee Insurance is provided by National Insurance Company (NIC)
  - Government owned entity
  - NIC insures banks for up to 75% of their mortgage lending risk
  - Insurance costs are passed on borrower (up to 2.75% up-front fee on loan amount)
- Government provides subsidies to lenders
  - Subsidised loan to finance down-payment
  - Definition of interest rate cap for loans granted under this scheme

Risk analysis (I)

	+	-
Credit risk	• Conservative lending policies prevail • Credit bureau • Mortgage default insurance	• Mortgage default insurance schemes may deter decisions on loans • “Euroised” loans may lead to higher defaulting loans
Liquidity risk	Financing of mortgage through international credit lines	Deposits are short term
Interest rate risk	Some banks offer variable rate loans	Particularly domestic owned bank do not apply risk adjusted pricing
Exchange rate risk	Is passed on borrower	

Risk analysis (II)

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	+	-
Cost to borrowers	• Rising competition has decreased interest rates • Two products: home improvement loans and mortgage loans	• Requirement of guarantor • Deposit requirement • Insurance premium • Lending in foreign currency
Cost to lenders	• Mortgage default scheme reduces credit risk • Knowhow transfer from international banks	• New NBS measure increased cost of funds • Increased competition has squeezed margins • External factors may influence banks' profitability

Risk analysis (III)

	+	-
Cost to government	• Tighter rules on lending • New law on mortgage	• NIC Scheme is a contingent liability • Subsidy scheme supports market distortions
Stability and sustainability	• Foreign banks' presence support market development • System appears adequately supervised and liquid and well capitalised	• Improved affordability has to be proven over time • Financial stability is questioned by euroisation and rising non-performing loans

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