



**Economic and Social
Council**

Distr.
GENERAL

TRADE/WP.5/1999/6
17 September 1999

Original: ENGLISH

ECONOMIC COMMISSION FOR EUROPE

**COMMITTEE FOR TRADE, INDUSTRY AND
ENTERPRISE DEVELOPMENT**

Working Party on International Legal and Commercial Practice
Forty-eighth session
Brno, Czech Republic
29 November – 1 December 1999
Item 4 of the provisional agenda

USE OF LAND AS SECURITY FOR A LOAN

Note by the secretariat:

This paper was prepared by Mr. Robert Hall* at the request of the secretariat as a contribution to the Guide to Financing Private Enterprises and Trade to be discussed under item 4 of the Agenda.

This document has not been formally edited by the secretariat.

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Introduction

1. The creation of an interest in land in a manner which is capable of being used as security for a loan is essential for the encouragement of investment (both domestic and foreign) in transition economies. This, in turn, requires the establishment of a clear land policy by the government of a transition economy. Finally, at the root of any such scheme, is the essential pre-requisite that, in conjunction with the development of the use of land as security for loan, there must, at the same time, exist a market in real estate.

Use of Land as Security

2. Privatisation started the process of giving real value to assets (rather than having them valued at their historic cost).

3. Where land is concerned, a most important benefit of privatisation is the establishment of conditions under which a privately owned interest in land can be used to raise money (i.e., as security for a loan). This requires the existence of a market in real estate because the corollary of the creation of a mortgage or charge over land is that the interest charged can, in the event of default, be sold in order to recover what is owed, thereby depriving the owner of his interest in the land.

4. This process uses an asset that every country in the world has: land. All that is required is the creation of the legal and organisational infrastructure to enable that asset to be used in a way which can release extensive benefits.

Benefits to the Economy

Benefit to Public and Private Sectors

5. The ability to create a mortgage on its own has no value. A mortgage will only be of use to and benefit the economy if it results in further release of means of exchange (that is, money) into the economy, or the borrower uses the money raised as capital to create something else (e.g., a business or an asset) which in turn provides, for example, employment.

6. For an individual owning an interest in land, the benefit is that the land having value can be used to realise capital or can be used as security for a loan on appropriate terms, thereby providing funds which the borrower can use for other purposes. The benefit for the State is two-fold: first the possibility of levying tax on land transactions and associated matters. The second is that such ownership will increase the prospect of the property owner having what may broadly be termed as “a stake in the country and the economy” and thereby lowering the risk of criminal or subversive activity with regard to land.

TERRE Initiative figures - 30% of GDP

7. Recent studies for the TERRE Initiative (formed to support the achievement of the objectives being promoted by the Real Estate Advisory Group operating under the auspices of the UN/ECE) have shown that the effective establishment of the use of interests in land as tradable assets, with all the associated requirements (e.g. efficient retail banking systems, developed property and life insurance arrangements, etc.) can result in the increase of a nation's GDP of up to 25/30%.

8. It can be shown that, in general, countries which have less well-developed systems related to the recognition of and trading in private interest in land receive far less foreign investment than countries with developed systems.

9. A 1997 study carried out by the Economist Intelligence Unit for the UK's Royal Institution of Chartered Surveyors has found that although statistics on foreign direct investment (FDI) flows into real estate are not standardised and largely ignore the property market (as most statistical agencies regard real estate as a special case):

“a rough estimate on the basis of existing data would imply that the real estate component of [total global] FDI could be anywhere from 5 to 20 per cent of the total. Either way, the real estate sector is significant. At the low end of the estimate it attracts more FDI each year than the whole of Eastern Europe and the former USSR, at the high end it attracts nearly double the FDI of China”.

10. In the year in question, the total FDI flow was in the region of US\$350 billion. Five per cent of that figure is US\$17.5 billion and 20 per cent is US\$70 billion.

11. Another study has shown that, in 1995, of the total global FDI flow some 7 per cent went to Eastern European and the former USSR. Of that sum, approximately 75 per cent had, as its destination, Hungary, Poland and the Czech Republic. The accordingly relatively small balance was spread unevenly across the rest of the region.

12. It is not suggested that the absence of reliable, transparent and predictable systems for dealing with interest in land is the only reason for the low FDI flow. It is, however, indisputable that countries not having adequate title and land ownership arrangements receive significantly less or very small amounts of FDI. In addition, it is clear that often prospective transactions and loans founder because of the absence of proper title.

Encouragement for Future Lenders

13. The benefits to the economy which develops a system enabling the creation and enforcement of loans are significant:-

- Where such a system exists as part of a broader reform of land issues and the creation of a market in real estate, it is estimated that there can be an injection of spending power into the economy of somewhere between 20 and 30 per cent. In other words, the proper utilisation of land provides a significant stimulus to the economy.
- Properly based use of land as security for loans enables businesses to raise funds on its property assets, which can be invested in the business, thereby potentially improving efficiency, productivity and employment.
- The economy benefits in many ways: stamp duty on transactions in land, increased consumer spending (in turn generating income on which tax can be levied), increased employment, more productive use of the country's assets.
- The recognition that not all enterprises succeed is very important. It is, therefore, an essential part of the move towards the use of land as security that it be accepted that if the terms of the loan are not fulfilled, the lender must have the ability to sell the asset used as security for the loan. The very fact that such realisation exists and is implemented will encourage future prospective lenders to recognise that there is an exit for them from a defaulting loan. This will make them more willing to lend in the future.

Method

14. The ways in which loan transactions can be structured are many and there is no one required method. Certain common threads can, however, be found in any loan transaction. Some of the main principles are as follows:-

Valuation

15. It is essential that there should be a sufficiently established system of valuation principles so that the initial value assigned to an asset accurately reflects what that asset is likely to raise in the event of a forced sale in the market. When that value has been established, the lender can then assess the extent of the loan in relation to the value of the asset taking into account other relevant matters in respect of the prospective borrower (e.g. capacity to service the debt). A lender may, for example, have a rule that it will not lend more than the greater of a fixed percentage of the value of the asset offered as security or a figure which is a

fraction of the average of each of the last three years net profit after tax.

16. In order to provide reliability and transparency in valuation, it is essential that a reputable and approved system of valuation be adopted. A recent study commissioned and published by The European Group of Valuers Associations has produced proposals for common valuation standards representing the views of professional bodies throughout the European Union. Membership of the Group includes professional bodies concerned with appraisal from the European Union, with an active and growing associate membership from the European Economic Area, and Central and Eastern Europe including Russia, the Czech Republic, Hungary, Poland, Bulgaria, Romania and Albania. The Group works closely with the International Valuation Standards Committee. Common standards and methodology enable consistent values to be reported for both public and private purposes with significant benefits to commerce and industry as well as to the financial and institutional investment sector, and the wider population that depends directly or indirectly on the economic efficiency of these undertakings. The European Valuation Standards are not mandatory on member organisations, but are recommended for adoption as representing best practice that incorporates relevant European Union legislation and the main thrust of thinking in Europe and internationally. The ultimate objective is to promote the concept of clarity, economic reality and transparency in reaching valuations.

17. It is also essential that information is shared, published and available to all who need to use it. This has inevitable benefits:-

- It helps to underpin the accuracy of valuations.
- It enables potential borrowers to assess for themselves the potential their assets have as security for loans.
- The transparency of a market, thus established, encourages more prospective lenders to make themselves available at more competitive - and therefore beneficial - rates.

Basic Terms of Loan Agreement

18. The interest of the lender must be secured on terms generally accepted as being reasonable. These essentially comprise:-

- The promise by the borrower to repay the sum lent.
- An agreement by the borrower to pay specified interest on the sum lent. This may be at a fixed or floating rate of interest.
- An obligation on the borrower to preserve the asset in such form as, should circumstances

require, the lender can sell it in reasonable condition.

- Agreement that in the event of breach of the terms of the Loan Agreement (e.g. failure to pay the interest due or failure to preserve the asset, bankruptcy or failure of the borrower, etc) the lender can initiate the agreed procedures to sell the assets in the open market in order to seek to recover the loan, the repayment of which has been put at risk by the events affecting or caused by the borrower.

19. The process by which the lender seeks to recover its loan may be prescribed by statute or determined by the contract settled between the parties. It is, however, essential that the lender should be able to initiate steps properly and recover its loan with reasonable ease in the event of the occurrence of agreed triggering events. In the absence of confidence in their ability to take steps to recover a loan in specified circumstances, lenders will be less willing to lend - with all the adverse consequences which this necessarily entails.

Title/Registration Issues

20. Where interest in land is concerned, the lender must be able to check that the title of the interest in land offered as security is good. In other words, the lender or its representative must be able to investigate title to the interest offered as security. This can either be permitted as a matter of course or only with the express authority of the prospective borrower.

21. This essential pre-requisite to the making of a loan in turn requires that transparent and reliable systems exist and operate for the establishment of clear titles to interests in land.

Protection of Lender's Interests

22. Consistent with the basic requirement that the lender must be able to seek to recover its loan in the event of non-compliance with the terms of the loan, it is essential that the interest of the lender must be protected. This can generally be achieved by one of two ways:-

- Holding the title deeds to the asset.
- If, in the event of a subsidiary loan or for other reasons, the lender is not able to have the title deeds as evidence of the loan, there must be a system whereby the lender can register notice of the fact of its loan which is good notice in respect of the interest in question against any subsequent prospective lenders or purchasers. Accordingly, it is essential that a reliable and transparent method should exist whereby subsequent acquirers of the interest in land are put on notice of the existence of prior interests.

Protection of Borrower's Interests

23. It may be appropriate to protect a prospective borrower against penalty-type terms in loan transactions. This can be achieved by, for example, prescribing by legislation a standard form mortgage or by defining a maximum permissible rate of interest or penalty payment in the event of breach. The deemed desirability of legislative and administrative intervention of this kind needs, however, to be balanced carefully against the importance of ensuring as free a loan market as possible so that the availability and flexibility of loans can be determined by and reflect market conditions.

Enforcing a Security

24. As indicated earlier, it is an essential feature of the system of providing security for loans that the asset charged as security can be sold if certain events happen. Once these triggering events occur, then, on appropriate notice, the lender must be able to take steps to recover its security. These can either require the obtaining of a court order authorising sale or the establishment of the appropriate procedures whereby a specified individual is appointed by the relevant claiming body for the express purpose of administering the asset or arranging its sale in order to seek to recover the amount loaned, the cost of recovery and outstanding debt servicing payments.

25. Statute must provide for the protection of the purchaser of the interest in question. Thus, the subsequent purchaser must be able to acquire good title to the property, clear from the earlier interest of the borrower and cleared of the interest of the former lender. The intention is that the subsequent purchaser must be in a position to sell the property to another purchaser, freed of any earlier encumbrance of ownership in respect of the property (other than any interest prior to the defaulting owner of which proper notice has been given - e.g. covenants as to use affecting the land).
