

LAND MORTGAGE AND ECONOMIC LAND EVALUATION

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Abstract

The aim of the present study is to overview the situation and possible ways of moving forward in the field of land-property mortgages. Taking into consideration that virtually no official information is available on the land mortgage lending, therefore secondary research has been conducted primarily on the basis of literature. The topicality of the theme is given by the fact that in the business activities of the specialized financial institution established for the land mortgage lending, the proper activity of genuine land mortgage lending has a negligible weight and at the same time agricultural contractors are fighting with capital shortage.

1. INTRODUCTION

Land-property mortgages make it possible for landowners (entrepreneurs) to use their real estates in order to secure their credits. The ownership of the property which secures the mortgage loan remains with the owner and is not assigned to the party who is entitled to have the lien. Mortgage is a type of loan which security interest is granted in a form of property. The borrower of the mortgage has to provide an exact amount of money for the owner of the real estate, called the installment. If the debtor does not complete the payment obligation, the lender receives satisfaction from the property.

In case of land-property mortgage loan, the lien is not dependent on the ownership of the security. This characteristic of this type of loan is highly important in agricultural production; since the agricultural properties may serve as the security of mortgage loans, even those owners (individuals and entrepreneurs) can receive the loan who do not own any other means of security apart from their agricultural real estates and tools.

2. THE SHORT HISTORY OF LAND-PROPERTY MORTGAGE IN HUNGARY

In Hungary, people have been receiving loans for agricultural purposes since the 14th century, but only since the 1800s has the need for an institutional organization of land mortgage system emerged, due to the sudden increase in the need for loans in the agricultural production, which was a result of the fact, that market production became more and more common throughout the country. Entrepreneurs had to calculate with the time difference between their investments and the revenues, thus needed to draw in fresh capital as well. In fact, it was nothing more but the provision of constantly emerging costs in advance. With the abolition of the Hungarian law of inheritance in the 19th century, the free transaction of land was established. Due to the emergence of the Austro-Hungarian Monarchy, the market was expanded, thus stimulating an ever increasing agricultural development in the 1800s.

In 1925 two important measures were implemented:

- On one hand, Article XV. of 1925 legalized the placement of mortgage in a foreign currency, thus issuing debentures for foreign currency.
- On the other hand, the government provided the institution an amount of money worth 150 thousand dollars for the allocation of mortgage loans with the restriction that the debentures would have not been issued for a while.

Later, several other times, the institution, due to the increasing need for help in the agricultural production, received more resources for the sake of other loan allocations. Finally, in 1928, the institution could start the issuing of debentures.

The latest land mortgage system was formulated in the decade following the change of regime in 1990. The FHB land credit and mortgage bank was established as a specialized institution by four banks with a fund worth 3 billion HUF. It received its operating permit from the Hungarian Financial Supervisory Authority in March 1998. FHB ensures the resources for its own and the refinancing loans by issuing debentures. In the summer of 2001 the debentures of the bank was introduced to the Hungarian Exchange Market. From 2006 on, FHB continues its operation under the name of FHB Mortgage Bank Co. Plc. (FHB Nyrt.) FHB Real Estate Ltd. is specialized in assessing, managing, mediating, counseling and expertise of real estates concerning inner and outer orders from the bank group. One of its well-known product is the FHB housing price index and the FHB land index.

3. INTERNATIONAL OUTLOOK

In Europe, the one-level system is the most widespread and even the Hungarian system originates from the German financing system based on mortgage debenture existing since the 18th century. From a legal point of view, the German legislation integrated the EU principles of land mortgage system in its own. Thus, mortgage debentures can only be issued by banks with special permissions (Hypothekbank), while other banks can perform mortgage lending activities.

Mortgage banks are supervised uniformly by the so called Bundesaufsicht für das Kreditsystem (Hitelrendszer Szövetségi Felügyelet) institution. In other cases, the Credit Act 13. 04. 1993 applies to the banks.

Mortgage banks issue mortgage debentures for private national properties, and provide communal loans for the same properties for city councils and thus provide communal mortgage debentures for their land securities.

The registry of the European Union do not show separately the trends within the agricultural land-property mortgage from other mortgages but loan banks within the supremacy of the European Union can freely operate according to the 23. Article of the 2006/48/EK directive which applies the so called “seat principle”, i.e., any loan bank which possesses a legal permission can operate in any other member state of the European Union without further approval processes being involved.

The Forum Group on Mortgage Credit (2004) urges the unification of the assessment system in its proposal and considers it an important objective to use rented properties as securities in order to broaden the importance of the land-property mortgage system.

For the request of the European Commission, London Economics (2005) by applying the Oxford Economic Forecasting (OEF) macroeconomic model examined the need for the higher-level integration of land-property mortgage markets. For the examination of the efficiency loss of the land mortgage market [1] the research utilized the Greenwood-Hercowitz theoretical model, regarding the land mortgage markets, which originates from the neoclassical economic growth theory. For determining the levels of land mortgages, the model hypothesizes perfect competition and that land mortgages enable the younger demographic to purchase real estates (Greenwood and Hercowitz 1991). Based on the results, [2] the elaboration of a common assessment framework, a database for credit and real estate transactions, the improvement of the real estate registry and land-property mortgage execution and the strengthening of the market nature of risk-taking were suggested for the further improvement of the integration.

The white book about the „Integration of the land-property mortgage systems within the European Union” suggests to include the integration of land mortgage system within the official policy of the EU, which would result in the increase of the compatibility and efficiency of the land mortgage markets.

4. THE PRACTICE OF LAND-PROPERTY MORTGAGE REGARDING AGRICULTURAL PROPERTIES IN HUNGARY

Spilákné Kertész Márta (2012) argues that „the improvement of compatibility and the configuration of an efficient plant size within this sector require a significant credit demand. The required amount of capital cannot be supplied solely from own resources, but the use of other outer sources are needed as well: international and EU subsidies, securities-based bank credits, etc. Land mortgages can also serve as a source of fresh capital.”

According to the official coverage, the annual interest rate of average land-property mortgages with a five-year long interest rate period is 9.59%. The price of the estimation of loan-to-value ratio in the case of agricultural lands, plough lands, vineyards and orchards, depending on the complexity and size of the territory, varies between 30-70 thousand HUF. In the case of non-purpose loans, the annual interest rate can reach 13%.

(Source: www.fhbindex.hu/FHB-Index/FHB-Termofoldindex)

As Árvai et al. (2008) point out, the size of a mortgage is defined by the credit demand and creditability of the agricultural sector, as well as the value of the lands potentially involved in land mortgages as securities. Thus, we can conclude that land mortgages are highly dependent on the conditions of capital market, the land market and last but not least, on the income generating capacity of the agricultural sector.

The basis of land-property mortgage is the market value of the lands provided as securities. Based on particular calculations, the estimated value of the 4.7 million hectare big plough land is 700-900 billion HUF, while the value of the total creditable lands is 30-40 billion HUF.

[1] In the economy, efficiency loss is caused by the fact that banks borrow money with an „ r ” interest rate but loan it with an interest rate of „ $r+s^1+s^2$ ” (where s^1 is the expenditure and s^2 is the profit of the banks) It is most probable that „ s^1 ” causes actual national economic loss, while „ s^2 ” returns back to the consumers (capital owners).

[2] On the basis of the research results, the integration of the land-property mortgage markets would result in a 100 billion Euro (0.9% of the GDP in 2005) direct profit in a medium term, which would increase consumption with 0.5% and the GDP with 0.7%

5. LAND-PROPERTY MORTGAGE LOAN SYSTEM CAN BE PUT ON A NEW BASIS

According to Kökényesi, the importance of land-property mortgage loans might become increasing in the agricultural sector. It is mainly supported by the strengthening of agricultural entrepreneurs and the positive changes seen in the structure, but the ever increasing cooperation between the loan banks and the Hungarian National Land Fund (NFA) has an important role in it as well (purchasing and reusing the securities of overdue land mortgage loans, etc.) (Kökényesi L. 2004).

However, the quintessential problem of the land-property mortgage system is, and it is supported by the history of the Credit and Mortgage Bank's operation, that the relatively small-scale transactions would require the operation of a large banking apparatus with small efficiency and bad productivity indices.

Therefore, when contemplating on further developments, it is the most practical to consider three main issues:

- land concentration and the establishment of companies which are entitled for mortgages secured by agricultural lands;
- adopting a plant control system where the security of the mortgage is the plant itself (including all of its assets);

- setting down new, self-financing agreements which head mortgages for longer term agreement in order for establishing investment capacity.

Adapting the plant controlling agricultural model inherently suggests new opportunities.

The present legal plea of agricultural plants regarding the EU-27 member states based on the reform of the CAP 2003.VI.26 is the directive of 1782/2003/EK approved by the Council of the European Union on 29. September 2003. This did not only define the term of an agricultural plant, but also prescribed obligatory norms regarding all kinds of transactions.

In the plant controlling model, the material resources constitute the whole of the agricultural plant as a transactional unit. For the unification of these material resources in order to be able to be whole, it is needed to be officially registered including the inventory of the factors of production belonging to the agricultural plant. These factors which are listed in the inventory are no longer marketable or just in a strictly limited way.

This transition is going to be a gradual process which necessitates a previously conducted thorough preparative work. Until the establishment of this land transaction system based on plant controlling, lands will be available for sale. This facilitates the marketing of smaller lands, unless minimal plant sizes cannot be formed.

Generally, there are several factors affecting the value of the land (its price), among which the supply and demand is one of the most important; however we must admit that "...the economical use of the land is what truly determines the land prices on the market. For instance, the price paid for a land which is suitable for warehouse construction is determined by the net income derived from the costs of the construction and the revenue gained from the operation of the warehouse."¹ In the case of utilization for agricultural purposes, the increment of the given land is authoritative, but obviously, this can vary as well according to the relationship of supply and demand serving different interests. The main point is that land prices fluctuate around the factor income expressing the expediency of the land.

The establishment of a plant controlling based land mortgage system necessitates the reconsideration of the practical details of land mortgage loaning and its implementation in the complete system of agricultural financing.

Observing the price of agricultural land and the changes in its price has been in the centre of the interest of several researchers and institutions and even nowadays it is getting more and more prioritized. Agricultural land is such a resource of production whose price is influenced by a lot of factors so expressing it numerically is extremely difficult.

HCSO did not use to have proper data on land transactions till April 2012 when access was granted to the database of the National Tax and Customs Administration. According to the cooperation agreement between the two institutes the Office is given the records of land purchase transactions every quarter of a year on the basis of which calculations are carried out using its own views and the methodological requirements of EU.

However, Eurostat pointed out that there actually are significant differences between land prices in certain countries. The comparability of data is also made more difficult by the different methodology they use. That is why in 2009 the statistical office of EU with the participation of the member states drew up standards that are to be used in land price statistics. Although the current regulation is based on gentlemen's agreement, efforts are made to create an official legal environment.

Member states have been using harmonised methodological principles since 2011. HCSO went back to EU requirements of 2009 so the entire timeline available is based on similar methodological bases.

¹ The first Hungarian edition of book of American Institute of Real Estate Appraisers 1994, Kossuth 238. p.

6. THE DEFINITION OF AGRICULTURAL LAND PRICES

Agricultural land price is the settled counter value of land purchased for agricultural purposes per hectare where the area of concern includes the purchase of all land uses by farmers or agricultural organizations and does not include non-agricultural transactions (lifestyle purchases, construction etc.) or land exchange between relatives. (*Eurostat definition*)

HCSO carries out calculations on the following five land uses:

1. Arable land

It includes all areas under regular cultivation regardless the way agricultural tasks are carried out or the area is not used for crop production temporarily (left fallow). It includes nursery gardens (ornamental and fruit trees, vine, forests) except nursery in the forest established to satisfy the own needs of the farms, perennials (such as alfalfa and strawberry) and the area of herbs and spices. It may also include the garden planted with cereal crops and horticultural plants if production is not intended to satisfy the needs of persons working in the farm. The so-called temporary grassland, which is part of the crop rotation in the farm planted within 5 years, is also accounted. (*HCSO definition*)

2. Grassland

The land used as pastures and meadows belongs here, i.e. area situated on the same land and used primarily by mowing or grazing at least for 5 years. (*HCSO definition*)

3. Vineyard

The term is applicable for areas of continuous vineyards where vinestock can be found at a regular distance between rows and stocks and the main cultivar is grape. Vineyard is also applicable to the area within the garden (trellis) provided its area reaches 200 m². Vineyards not productive yet and vineyards already non-productive are accounted. (*HCSO definition*)

4. Orchard

Area covered by fruit bearing trees or bushes where the main cultivar is fruit tree or bush. Orchards can contain different species. Orchards also contain in addition to the productive plants ones that are not productive yet or already non-productive. In terms of land use orchard also means an area around the house covered by fruit trees or bushes (at similar distances between rows and stocks) if it reaches or exceeds 400 m² in the case of trees and 200 m² in the case of berries. (*HCSO definition*)

5. Forest

Forests are areas covered by trees or shrubs including nurseries in the forest established within the forest for the private use of the farm. Protective forests against the wind and hedges etc. belong to the category of forest (except forestry nurseries for commercial use and those out of the forest) if they are accounted as forests. It also includes the area of Christmas tree plantations. (*HCSO definition*)

The source of land price used in calculations is the list of land purchase transactions taken from the National Tax and Customs Authority within the framework of cooperation. The database includes unique records with non-identifiable identification at transfer. Several variables are attached to each record, which make it possible to examine data reliability and punctuality and it also contributes to complex examinations.

Correcting the seemingly faulty data is an inevitable part of precise data processing. The fact that prices fall into a wide acceptable range must be considered when it comes to modifications. Due to influencing factors (such as culture, land quality etc.) they can move within a wide range. An issue can arise from here, namely, if it is obvious to tell apart what an error is and what a real but significantly moderated or extremely high price is.

During the outlier filtering the Office relied on the minimum and maximum average prices of land sale transactions observed at the general agricultural census of 2010. Acceptable intervals were defined in

this way per land size, which differ from county to county. On a national level this scale is relatively wide in the case of arable land, e.g. 100 000 and 3 000 000 Ft per hectare.

7. FURTHER POSSIBILITIES

In certain states of the USA, warehouses operate as private establishments. Financial institutions, individuals with storage capacity and agricultural producers (farmers) are members of the enterprises. Warehouses acquire a certain percentage of the expected yield from the farmers if they face financial difficulties, then these crops belonging to the warehouses are sold for the most favorable price on the stock exchange. The thus gained profit is redistributed to the members of the warehouse based on a previously set proportion (usually according to capital ratio). Thus, farmers are not placed in state of emergency regarding the advanced purchase of resources needed for the production and they do not have to sell their products under a reasonable price.

It is also worth to consider how the establishment and operation of such a new (American) type of warehouse system would reduce or limit to a minimum the need for short-term loans and focus more on strategic, long-term loans and development schemes.

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