Executive summary of the public audit report

HOUSING MORTGAGE INSURANCE: DOUBTS ABOUT BUSINESS CONTINUITY

20 December 2013 No. VA-P-60-9-23

Full audit report in Lithuanian is available on the website of the National Audit Office: www.vkontrole.lt

DEFINITIONS

Company means the joint stock company Housing Mortgage Insurance.

Policyholder means a person who has concluded an insurance contract with the joint stock company Housing Mortgage Insurance.

EXECUTIVE SUMMARY

The establishment of the joint stock company Housing Mortgage Insurance by a Government resolution[1] paved the way for the insurance of residential property credits in Lithuania, which was started in the year 2000. The housing mortgage insurance allowed people with regular income, who, however, were not able to accumulate or did not have the required initial bank contribution, to buy a housing with a smaller or without any initial contribution.

This is the only company in Lithuania providing mortgage insurance. The number of families and individual persons who have used the services of the Company since its foundations totals 46,000, the Company has insured about LTL 4 billion of mortgages issued by banks.

Since 2006, the Company was also insuring credits for the modernisation of apartment houses. There are more than 100 apartment houses associations which insured such credits at the Company.

The Company suffered an adverse effect of the financial and economic crisis which began at the end of 2008: the number of mortgage insurance contracts rapidly declined, reaching zero in 2013, whereas the number of insured events went up. Since 2009, the Company has been operating at a loss, the losses incurred over the period from the 1st half of 2009 until 2013 totals almost LTL 170 million. To ensure the Company's further operations, the state has been allocating funds for the fulfilment of the commitments undertaken by the Company. In total, since its inception, including the authorized capital of the Company formed at the moment of its establishment, the Company has received LTL 157 million of state funds and a loan in the amount of LTL 20 million from the funds borrowed on behalf of the state.

The objective of the audit was to assess the effectiveness of the performance of the company Housing Mortgage Insurance by answering the following questions:

- Does the Company carry out the mortgage insurance activities envisaged in its Articles of Association?
- What is the financial situation of the Company?
- Does the Company use effective models for regulating the support to policyholders and cash flows.

The audit was conducted at the joint stock company Housing Mortgage Insurance and the Ministry of Finance of the Republic of Lithuania, information was also collected from other entities, such as the Central Bank of the Republic of Lithuania and the Association of Lithuanian Banks.

The audit covered the period from 1999 to the 1st half of 2013. Some data from later 2013 was also used for analysing trends and changes.

The following public audit conclusions and recommendations were drawn upon the assessment of the audit findings.

CONCLUSIONS

Until the year 2009, the company Housing Mortgage Insurance was profitable; however, due to the increased number of insured events and a virtual standstill of new contracts, it has been

[1] Government of the Republic of Lithuania Resolution No. 739 of 18 June 1998 on the housing mortgage insurance company.

incurring only losses over the past five years – the result of its operation from 1999 to the 1st half of 2013 was losses in the amount of LTL 122.9 million.

1. The business continuity of Housing Mortgage Insurance, as a for-profit insurance undertaking, is subject to serious doubts, because:
   1.1. the Company has not been conducting the business for which it was set up: not a single housing mortgage insurance contract was concluded in 2013 and no insurance contracts on credits for the modernisation of apartment houses were concluded in 2012–2013;
   1.2. the recovery carried out by the Company has been failing to ensure adequate cash flows: only 14 per cent of the sum of the insurance benefits paid to the banks was recovered until 30 June 2013, i.e. LTL 33.3 million out of LTL 240.8 million;
   1.3. the Company is not able to meet its obligations and the requirement of the Law on Companies concerning the ratio between the equity and the authorised capital without additional injections of public funds (which totalled LTL 170 million)
   1.4. despite the additional public funds allocated to the Company, since 2011 the Company has not been meeting the requirement concerning the coverage of insurance technical provisions with appropriate assets, which is mandatory for an insurance undertaking under the Law on Insurance;
   1.5. if the Company attains the results provided for in the Commitment Plan for 2013–2017, its financial problems will not be solved: the amount planned to be recovered by 2020 is LTL 225 million, however, this accounts only for 66 per cent of the benefits for insured events which was supposed to have been recovered by 30 June 2013.
2. The management bodies of the company Housing Mortgage Insurance – the Ministry of Finance, the Board of the Company, and the Director of the Company – did take measures to reduce the losses of the Company and stabilise the cash flows, such as increasing and reducing the investment capital, paying benefits to banks in parts over several years, and introducing support models. However, the measures were not sufficient to ensure the break-even operations of the Company. In addition, the obligation imposed on the Board by the Bank of Lithuania to consider the issue of the expediency of the insurance business and prospects of the Company's activity by 1 October 2013 and to inform the Bank of Lithuania on the decisions taken has not been met.
3. The Ministry of Finance, which manages the state-owned shares of the company Housing Mortgage Insurance by the right of trust, and the Board of the Company have not developed any alternatives for the restructuring of the Company.

RECOMMENDATIONS

To the Ministry of Finance:

In order to ensure rational use of public funds and taking into account that:

- as of 30 June 2013, the company Housing Mortgage Insurance was administering 35,001 valid insurance contracts, the commitments of the Company under these contracts totalled LTL 3.5 billion;
- the support measures (models) applied by the Company have helped to retain the housing for 70 per cent of the policyholders (2,071 families or individuals) faced with financial difficulties;
- the last insurance contract expires in 2047;

- the insurance business licence of the Company was suspended on 21 November 2013, i.e. the Company may not conclude new insurance contracts,

the Ministry should submit proposals to the Government on the expediency of the business of the company Housing Mortgage Insurance and/or transformation of the Company's business model.

The Action Plan for Implementing the Recommendations specifying the measures and deadlines is given in Annex 2.