Responsible Lending in Banks of the Baltic States

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ABSTRACT

The aim of this article is to clarify basic principles of responsible lending in lending agreements between banks and individuals in Latvia, as well as in the existing legislation in the Baltic States that regulates this process.

In order to obtain research results, the authors performed qualitative analysis of scientific literature on the issues of responsible lending; legislation that regulates mortgage lending in the Baltic States; successful experience of banks in other countries; information available on home pages of banks about commercial bank loan volumes for mortgage loans with different types of real estate asset backing; information included in loan agreements of four commercial banks in Latvia and its compliance with the laws and regulations. Loan borrower evaluation stages for review of a new loan application were developed. On the basis of loan agreement analysis, the authors elaborated a formula of monthly loan payments for bank customers who experience unfavourable financial conditions.

As a result of the research, the authors came to a conclusion that in Latvia and Estonia there is no legislation that directly regulates mortgage loans.

During the research the authors also faced some restrictions, as not all banks in Latvia, which continue lending activities, are willing to give information included in loan agreements.

Keywords: Responsible lending, laws and regulations, banks, the Baltic States.

1. INTRODUCTION

Banks play a major role in financing of entrepreneurship and services in all sectors of the national economy, thus it is essential for bank analysts to evaluate solvency of customers by reviewing new loan transactions and thus avoiding unforeseen expenses that might occur as a result of irresponsible financing of loan transactions and in such a way maximally decreasing both social and financial risks.

The issue of responsible lending came into focus and started to get solved upon the onset of financial crisis that caused consumer distrust in the banking sector as such, thus unambiguously resulting also in higher payment for products and services offered by banks. One more important factor is that loans play an important role in all national economies; it was clearly seen in Latvia as well, creating an opportunity for entrepreneurs to purchase new and modern manufacturing equipment in the pre-crisis period, thus increasing competitiveness. It was also confirmed by the statement of the European Commissioner for Internal Market and Services Charlie McCreevy: “The financial crisis has shown the damage that irresponsible lending and borrowing practices can have on consumers, lenders, the financial system and the economy at large” [1].

Many banks in the world and also in the Baltic States carried out aggressive market drives by dumping loan interest rates in relation to their competitors, thus disregarding human capital and its significance. Already in 2006 Watchman et al. mentioned that creditors should change their aggressive loan policy to a new one that would be based on environmental issues, sustainable development and human resources, in such a way directing banks towards responsible lending [2]. However, the Centre for Responsible Lending mentioned the consequences in the real estate market that led to its stagnation as the main problem of irresponsible lending [3].

The purpose of the research is to find out how the basic principles of responsible lending in lending agreements between banks and individuals in Latvia are followed, to study the existing legislation in the Baltic States that regulates this process.

The object of the research is responsible lending in the Baltic States.

To achieve the goal, the following research methods were used: quantitative and qualitative methods, including the method of sociological research and the descriptive method.

2. LITERATURE REVIEW

With the beginning of the financial crisis, in the scientific literature great attention was devoted to responsibility of banks for credit products they offer, especially making topical the issue of responsible lending. So what is responsible lending? There is no unambiguous answer to this question in the scientific literature; it mentions only that it is regulated by directives that specify information to be included in loan agreements and that the creditor has to evaluate the borrower’s solvency to meet their liabilities in present and in future.

Already in 2005 Hutchings in his research mentioned that banks do not perceive their mutual competition as an advantage but rather as their ability to develop responsibility for services offered by banks [4]. However, Bricker et al. emphasized that responsible lending is also based on asset creation that includes also total assets of households [5]. In other literature sources it is stated that responsible lending is not based only on financial factors but also on environmental factors that include also sustainable development [6].

Banks not only in the European Union but also in the entire world increasingly consider responsible lending to be one of the prerequisites for successful development. It has also been stated by the Bank of Montreal Financial Group that banks focus on responsible lending practice and development strategy, thus ensuring effective decision making [7]. For example, also in the Bank of Lithuania the principles of responsible lending are being implemented; they are based on loan-to-value ratio, risk management, as well as elaboration of rules based on domestic financial system's resilience against problems of market imbalance [8].

According to the Australian Securities and Investments Commission, credit licensees are also liable for responsible lending, as it is stated in Ch 3 of the National Consumer Credit Protection Act 2009 [9]. The main concept of this act is that a consumer does not have to sign a loan agreement if it does not suit him/her. At the same time, the European Commission, in accordance with the statement of the President of the European Council 2009-COM (2009) 114, undertook to come forward with measures at the EU level on responsible lending and borrowing, including a reliable framework on credit intermediation, in the context of delivering responsible and reliable markets for the future and restoring consumer confidence [10].

In the White Paper on the Integration of EU Mortgage Credit Markets it is defined what exactly refers to responsible lending and borrowing, including pre-contract information, consultation, evaluation of solvency, early repayment and credit intermediation [11]. For example, according to 2007 data, in the 27 EU member states the proportion of unpaid mortgage credits was 50.1% of European Union GDP, which in some member states, such as Spain, Ireland, Great Britain, Latvia and Lithuania, sharpened the consequences of the EU financial crisis [10].

2.1. Banking System in Latvia

The banking system in Latvia started rapidly developing after Latvia regained its independence. During the first four years from 1991 till 1994, 67 banks received licences. Although the total volume of actives in the banking system tripled in the years 1992–1994, only 47 out of 55 licensed banks at the end of 1994 were able to submit an annual report in the set time limits and only 16 of them finished the year with profit [12].

There were several reasons why Latvia had to undergo the banking crisis. The banking sector developed too fast and much faster than economic environment, in which this sector operated. Real estate and securities markets were not sufficiently developed to provide liquid asset backing for granted loans. Due to lack of experience, bankers and entrepreneurs made mistakes in crediting and in evaluation of business plans [13].

Another factor that led to irresponsible lending and borrowing in Latvia was the fact that the borrower was interested in receiving as cheap loans as possible, whereas the lenders and brokers were interested in providing as many loans as possible. This fact was also confirmed in the European Commission in 2011 [14].

Since June 30, 2010 Latvia holds possession of three banks – the newly established bank JSC "Citadelebanka" separated from JSC "Parexbanka" that now performs the functions of the settlement bank and State JSC "Latvian Mortgage and Land Bank" that performs also functions of the development bank (at the end of September 2009 its equity capital was 6.1% of bank's paid-up capital). With the decision of the government of the Republic of Latvia on February 27, 2009 85.14% of the state-owned shares of JSC "Parexbanka" were transferred to the State JSC "Privatization Agency". At the end of September 2009, JSC "Parexbanka" equity capital was 16.1% of bank's paid-in capital [15].

According to the data provided by the Association of Commercial Banks of Latvia (ACBL), in Latvia in the 1st quarter of 2013 banking services were provided by 20 banks and 9 foreign bank subsidiaries; the European Economic Area countries also established credit institutions or their branches, which submitted the application to the FCMC, with one bank – "VEF Banka" since 26 May 2010. License was suspended and JSC "Latvijas Krājbanka" filed for bankruptcy [16].

2.2. Laws and Regulations Regulating Responsible Lending in Latvia

Concerning the issue of responsible lending in the European Union, on March 31, 2011 the European Commission issued the final version of the Directive of the European Parliament and Council COM (2011) 142 – 2011/0062 (COD) on Credit Agreements Relating to Residential Property [14]. This directive refers to the European Union member states. It should be noted that several member states apply separate Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on Credit Agreements for Consumers. The above-mentioned directive refers to consumer credits from EUR 200 to EUR 75,000. The basic purpose of directive 2008/48/EC is to regulate promotional information, pre-contract information, information that should be included in the agreement, evaluation of solvency, proper explanations and demand for information disclosure with credit intermediation. The same directive refers to credits for purchasing real estate with mortgage security or equivalent collateral, or loans for housing reconstruction [17].

In Latvia, consumer rights are protected by a range of legislative acts that refer to both credits granted by banks and non-bank financial institutions: Law on Protection of Consumer Rights [18], Civil Law [19], and Regulations of the Cabinet of Ministers No. 1219 of 28 December 2010 on Consumer Credit that came into force on 1 May 2011 [20], European Union Directive 2008/48/EC [17].

In Latvia, mortgage borrowers' rights are protected by the Law on Protection of Consumer Rights of 1 November 2011 that came into force on 22 June 2011.

Section 8 of this Law sets special provisions with respect to loans for which repayment is secured by a real estate mortgage. The most essential terms for such loans:

1. Section 8, Clause 1 – a grantor of credit is not entitled to request from a consumer who has not made any significant violation of the contract:

Subclause 1 – additional security of the granted credit on the basis of reduction of the value of immovable property in the credit security due to the changes in the immovable property market;

Subclause 2 – any costs for revaluation of mortgage credit security during the term of the contract;

Subclause 3 – the pre-term repayment of the credit granted.

2. Section 8, Clause 2 – if a consumer who has not committed any significant violation of the contract asks to do it, the grantor of credit has the duty to examine the proposal of the consumer regarding extension of the period of time for credit repayment or change of the currency of the credit. In case of refusal the grantor of credit shall, within 30 days, issue a motivated reply to the consumer.

3. Section 8, Clause 3 – the changes in contract provisions referred to in Paragraph two of this Section may not be less favourable for a consumer in comparison with the existing market conditions at the time when the changes to be made in the contract are offered. The consumer is entitled to request the making of changes referred to in Paragraph two of this Section not less than once a year. The grantor of credit is not entitled to request any compensation for making of such changes, except a justified and reasonable payment for administrative expenditures of the service.

4. Section 8, Clause 4 – significant violation of the contract shall be considered:

Subclause 1 – delay of repayment of credit or interest payment for more than 60 days or more than three times a year for more than 30 days each time;

Subclause 2 – the use of credit for the purpose other than specified in the contract [18].

Another law that partly regulates mortgage lending is Regulations of the Cabinet of Ministers No. 1219 of 28 December 2010 on Consumer Credit [20]. These regulations are based on suggestions of Directive 2008/48/EC of the European Parliament and the Council of 23 April 2008. Regulations of the Cabinet of Ministers No. 1219 cover the issues that define calculation of annual interest rates; requirements for advertisement of crediting services; information that must be given to a consumer before signing the credit agreement; information that should be included in a crediting agreement (type of credit, creditor, agreement term, sum and terms of settlement, interest on delayed payments, consequences of default on payment); consumer notification; advanced repayment of credit.

2.3. Banking System in Lithuania

Likewise in Latvia, the banking system in Lithuania started rapidly developing after Lithuania regained its independence in 1990, despite the fact that the first commercial bank was established in 1989. Until 1992, the operation of commercial banks was regulated by the same laws that stipulated the operation of businesses; only later separate legislation was introduced [21].

The number of banks in Lithuania increased to 27 in 1993, but in 1996 it dropped to 13. One of the main reasons for the sudden increase in the number of banks in Lithuania was also dishonest and careless operation. In 2001, saving societies became popular, the number of which accounted for 41. Likewise in Latvia, the financial sector in Lithuania also experienced growth due to the foreign capital entry in 2002 [22].

According to the information available at the website of the Bank of Lithuania, in 2013 licenses have been issued to 7 commercial banks, 55 saving societies, 1 Lithuanian central saving society, 29 payment institutions, and 2 electronic money institutions [23].

2.4. Laws and Regulations Regulating Responsible Lending in Lithuania

In Lithuania, responsible lending is regulated by Resolution No. 03-144 of the Board of the Bank of Lithuania of 1 September 2011, with the following principles:

3.1. Before making lending decision credit institutions should perform consistent assessment of the borrower’s ability to repay the credit also in case of violation of contractual obligations;

3.2. Information about premature credit repayment conditions should be included in credit agreement;

3.3. Prior to credit granting a qualitative and quantitative assessment of the property must be conducted;

3.4. Maximum loan-to-value ratio for credits granted for purchase of real property shall account for 85% of the market value or price of mortgage. The same principle also refers to construction and is based on actual amount of work done. There are also exceptional cases when loan-to-value ratio may be increased up to 10%, if this Project is supported by the State and conforms to the requirements established by the Law of the Republic of Lithuania on the State Support for Dwelling Acquisition or Rent and Renovation (Modernisation) of Blocks of Flats; credits are supported by the State if the amount of granted credit does not exceed: for a single person – LTL 120 000 and for the family of two or more persons – LTL 240 000.

3.5. If the borrower is willing to purchase more than one residential property, the credit should be subject to tighter limits.

3.6. For purchase of agricultural parcels loan-to-value ratio may not exceed 40% of acquisition price or market value of the parcel being purchased.

3.7. Loan-to-value ratio for credits secured by mortgage of different types of property shall be calculated separately per property.

3.8. The average amounts of repayments of the principal and payments of interest shall not exceed 40% of income of both enterprises and households.

3.9. The credit granting decision shall be based on the history of sustainable income of minimum six months as well as current expenses.

3.10. If the credit currency differs from currency of the borrower’s income, additionally the exchange rate fluctuation risk should be considered [24].

2.5. Bank System in Estonia

The development of the Estonian banking sector also started after the re-establishment of independence. However, the banking system started to develop most rapidly in 1992, when the national currency was introduced. Along with the restructuring of the banking system the number of banks decreased. After the re-establishment of independence there were 42 banks in Estonia, in 1992 – 11 banks, but in 1997 – 6, which were influenced by the financial crisis in Russia in 1998. The financial sector experienced growth along with the inflow of the foreign bank capital into the country, but that, however, did not increase the number of the banks [22].

Banking sector in Estonia, just as it is in Latvia and Lithuania, is dominated by Swedbank and SEB banks. In Estonia the two above-mentioned banks constitute 70% of the total assets of the sector.

According to the information available on the home page of the Estonian Banking Association, in 2013 the banking sector is represented by 16 banks and their foreign subsidiaries, of which 12 are members of the Association. One of the members of the Association – UniCredit bank – terminated its activity in Estonia starting with 17 May, 2013 [25].

2.6. Laws and Regulations Regulating Responsible Lending in Estonia

Responsible lending in Estonia is regulated by the Credit institutions Act as of 9 June, 2010 (RT I 2010, 34, 182). Articles 83 and 89 of this Law envisage increasing transparency. The essence of this regulation is based on promoting customer awareness concerning products and services.

The Credit institution Act regulates both consumer loans and mortgage loans. On approval of the resolution Nr.1.1-7/62 of 1 July, 2011, this Law was supplemented with responsible lending regulation requirements. In turn, the Law 347 SE amended on 14 January, 2013, stipulates provisions for the act on liabilities and marketing, in such a way ensuring a more strict regulation for responsible lending.

Article 83 of the Credit institutions Act lays out responsible lending requirements:

Paragraph 3 – Specifies that upon provision of the loan the credit institution is obliged to observe the main internal lending principles of the credit institutions, the principles of good bank governance and responsible lending. In order to ensure that responsible lending principles are observed, the credit institution is obliged to collect and store the information on the amount of financial liabilities and the client’s ability to meet the commitments, in such a way determining and calculating a reasonable loan debt for the customers.

In turn, Article 89 of the Credit institutions Act (3^1) specifies that a credit institution is obliged to inform the customer on the potential threats, which may arise during the loan period [26].

The essence of responsible lending and its scope of application are defined in Part 4 of Responsible Lending Regulations (RLR) [27].

Responsible lending is defined in RLR as “manifestation of socially responsible conduct in the credit institution lending market”.

As demonstrated by the summarised information, in Estonia responsible lending is mainly based on the assessment of customer solvency, as well as on the storage of the information to inform other banks, if loan commitments are violated.

3. METHODOLOGY

In the research part the authors analyzed responsible lending credit agreements for mortgage loans for private individuals in Latvia.

To obtain results the authors performed qualitative analysis. Based on the reflections on bank credit changes from 2008 to 2011, the summary of the volume of crediting loans depending on different types of mortgage loan securities (apartment, house, land) in the Baltic States, as well as on the basis of credit agreement analysis in Latvian banks, the authors elaborated a formula for calculation of monthly loan payments in occurrence of unfavourable period for the client of the bank.

As the result of the qualitative analysis, the information about good practice of banks from other countries was acquired, for example, the data on Westpac Group (Australia), the Bank of America (the United States of America) experience regarding the issues of responsible lending and its basic principles, and information included in mortgage loan agreements of four commercial banks in Latvia and their compliance to the laws and regulations of Latvia.

The names of the banks were substituted with labels Bank 1, Bank 2, Bank 3 and Bank 4, because information included in credit agreements is not publicly available on the home pages of the banks. Stages for borrower evaluation were developed while reviewing credit applications.

4. RESEARCH DATA

To understand how other banks realized responsible lending, the authors performed the analysis of the terms for responsible lending in Westpac Group (Australia), the Bank of America (United States of America):

4.1. Westpac Group:

1.1. Offers its clients products and services that they can afford. This principle includes conformity to definite local legislation, credit evaluation policy created by the bank; evaluation of credit application that includes information available in databases in order to evaluate a client’s ability to repay; training of employees about criteria for granting loans; providing clients with information about possible loans so that they can evaluate their ability to settle the undertaken liabilities.

1.2. Product and service market is based on responsibility. The essence of the terms – in compliance with the principles of ethical and legal practice to inform clients about products and services provided by the bank; understand the demands and aims of the clients; estimate when the offered loan is not suitable for the client; promote client awareness of possible risks; client’s financial status is evaluated in case of increasing credit card limit and loan; loan agreement monitoring process.

1.3. Solutions for clients who got under financial pressure. Process based on mutual understanding between the bank and the client including remissions for clients who get into difficulties; search for solutions, loan repayment holidays.

1.4. Level of financial education of the interested parties. Based on public access to bank's money management, budget formation; finance education programme; availability of products and services; support local producers [28].

4.2. Bank of America:

Bank of America has accepted the responsible mortgage lending principles of National Association for the Advancement of Colored People (NAACP), that are based on responsible borrowing:

2.1. Loan terms will not be determined by a borrower's race, nationality, gender and other social principles.

2.2. Every borrower will have the option of selecting a loan product that is appropriate for his or her circumstances.

2.3. Institutions will seek to eliminate policies or practices that encourage biased and exploitive behaviours toward borrowers.

2.4. Borrowers will be approved only for loans they have a current ability to repay.

2.5. Each policy may be maintained and monitored for its racial impact.

2.6. All borrowers will have access to free information on existing loans.

2.7. Lenders will work with borrowers to prevent foreclosures.

2.8. Lending institutions will support and implement integration.

2.9. Workforce diversity in decision making [29].

On the basis of the Association of Commercial Banks of Latvia and European Central Bank data, in Figure 1 the authors have illustrated the total credit changes in Baltic States banks from 2008 to March 2011.

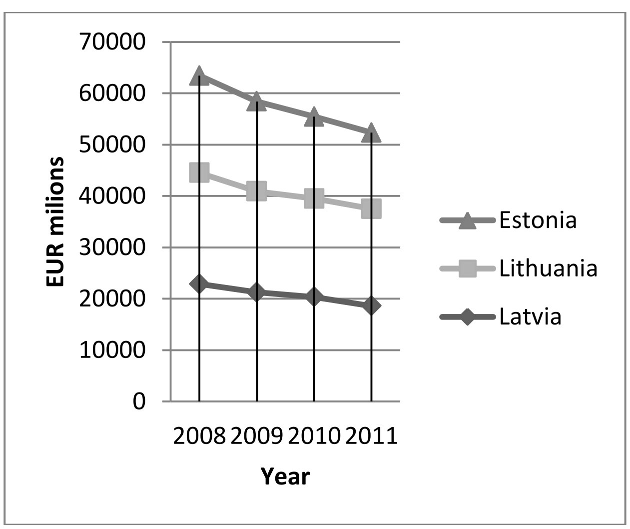

Fig.1 Changes in the volume of bank credits in the Baltic States

According to the information available on home pages of the banks, there are 9 banks in Latvia that actively offer loans to individuals: Citadele, DnB, Nordea, PrivatBank, Rietumu, SEB, SMP Bank, Swedbank, Trasta komercbanka. Whereas passively, without providing detailed information about the volume of the offered loans, 3 more banks offer loans: ABLV, Baltic International Bank, GE Money Bank. Some banks, such as Latvian Business Bank, Expobank, Rigensis Bank do not offer loans at all, Norvikbank offers consumer lending, Latvian Mortgage and Land Bank performs the functions of the development bank, Investment Bank offers loans to enterprises for current asset increase, UniCredit Bank also offers loans to enterprises.

According to the information available on the home pages of Lithuanian commercial banks, loans to private individuals are offered by SEB, Finasta, DnB, Siauliu Bankas, Swedbank, Medicinos bankas, as well as a range of savings and loan associations. However, in the course of research the authors analysed lending terms and conditions of commercial banks only.

Considering lending terms and conditions of the commercial banks offered to private individuals, it was observed that only three Lithuanian banks, namely, DnB, Siauliu Bankas and Medicinos bankas provide a more detailed information on the loan volume offered depending on various kinds of loan securities. At the same time, other banks have included information, which is based on responsible lending regulations, specifying that the maximum loan amount cannot exceed 40% of the total income.

At the same time, according to the information available on the home pages of Estonian commercial banks loans to private individuals are offered by SEB, Eesti Krediidipank, Swedbank, Citadele, Danske bank, Tallin Business Bank, DnB, Bigbank. However, more detailed information on the allowed proportion of the loan amount with relation to the market value is supplied by SEB, Swedbank and DnB, while other banks mention loan opportunities not specifying the potential loan amount.

To evaluate the current situation in commercial banks in the Baltic States concerning credit volumes to individuals, which are backed by real estate, the authors summarized the information available on home pages of the banks and presented it in Table 1.

Information included in Table 1 shows that the range of loan volume for purchase of housing and construction offered by Latvian banks varies between 70% and 90% of the market value of the property. At the same time, Lithuanian banks strictly observe responsible lending regulations, offering a loan in the range from 50% to 85% depending on the object pledged and the aim of the loan, as well as specifying that the lowest real estate value is taken into consideration, either the market or the purchase price.

In turn, Estonian banks, similar to Latvian banks, do not adhere to strict regulations, which would regulate the potential loan amount depending on the type of real estate. The provided volume of the loan varies from 85% to 90% of the market value of the real estate, however, DnB has specified that in case of real estate purchase the borrower has to co-finance minimum 20% of the loan volume, which can be partially (10%) replaced by KredEx guarantee.

Table 1

Volume of loans in commercial banks of the Baltic States

Name of the bank	**Loan volume for purchasing housing**	**Loan volume for construction**	**Loan volume for purchasing land**
	Latvia		
Citadele	Up to 70% of the market value of real estate (new mortgage)*, up to 90% of the market value (standard mortgage)	Up to 70% of the market value of real estate (new mortgage)*, up to 90% of the market value (standard mortgage)	Up to 70% of the market value of real estate (new mortgage)*, up to 90% of the market value (standard mortgage)
DnB	Up to 90% of the real estate value	Up to 75% of the value of house in future	No information
Nordea	Up to 90% of the market value of real estate	Up to 85% of the value of house in future	For purchase of land for building a house
PrivatBank	Up to 85% of the market value of real estate	Up to 85% of the market value of real estate	Up to 85% of the market value of real estate
Rietumu banka	70% of the market value of real estate	70% of the market value of real estate	50% of the market value of real estate
SEB	Up to 85% of the value of real estate	Up to 80% of the value of the building in future	No information
Swedbank	Up to 90% of the market value of real estate, 85% for standard projects	Up to 90% of the market value of real estate	No information
SMP Bank	Up to 90% of the market value of real estate	Up to 90% of the market value of real estate	No information
Trasta komercbanka	Up to 75% of the value of real estate	Up to 75% of the value of real estate	No information
	Lithuania		
DnB	Up to 85% of the market value of real estate or purchase price, depending on which is lower **	Up to 85% of the market value of real estate or purchase price, depending on which is lower	Up to 85% of the market value of real estate or purchase price, depending on which is lower
Siauliu Bankas	No information	Up to 50% of the market value pledging a land plot on which the construction will be built Up to 70%, if the apartment is used as a security Up to 85%, if the apartment is insured at “Busto paskolu draudimas”	No information
Medicinos Bankas	Up to 70% of the purchase price or the market price of the real estate, depending on which is lower Up to 85%, if the real estate is insured at „Busto paskolu draudimas”	Up to 70% of the purchase price or the market price of the real estate, depending on which is lower Up to 85%, if the real estate is insured at „Busto paskolu draudimas”	No information
	Estonia		
SEB	Up to 85% of value of the pledged real estate	Up to 85% of value of the pledged real estate	No information
Swedbank	Up to 90% of the market value of the real estate	Up to 90% of the market value of the real estate	No information
DnB	Co-financing starting from 20%, if KredEx guarantee is obtained, co-financing constitutes 10%	No information	No information

*New mortgage credit provides possibility to extinguish credit liabilities at any moment of credit agreement, transferring the mortgaged real estate into possession of the bank.

**Loan volume depending on different types of backing is not specified.

On the basis of the Law on Protection of Consumer Rights, Cabinet Regulation No.1219 and the EU directives, the authors, from their own point of view, performed evaluation of conformity of points included in credit agreements of 4 Latvian leading banks, to these regulations and their comparison to credit agreements in force in 2012.

The analysis of credit agreements showed that banks in their credit agreements have included information that is based on the existing legislation of Latvia and the EU concerning responsible lending and borrowing:

1. Creditor's identity;
2. Aims of credit use;
3. Duration of credit agreement;
4. Reference to currency, if the credit is taken in foreign currency, with explanation concerning the influence of credit in foreign currency on consumer;
5. Annual interest rate;
6. Sum and credit repayment instalments;
7. Frequency or exact dates of interest payment and other payments;
8. If the total amount of payment is not known, its calculation method is given;
9. List of payments related to credit;
10. Reference to the availability of advanced credit repayment and description of terms;
11. Reference to the necessity for property assessment and institutions that perform it;
12. Type of agreement security backing;
13. Liability for breach of terms of the agreement.

The issue concerning "the reference to the amount of expenditures connected with credit refinancing" was indicated only by Bank 4 without mentioning the amount of bank's planned commission. Bank 1, Bank 2 and Bank 3 did not include information about credit refinancing and associated expenses in their agreement terms.

What concerns the volume of mortgage loan, Bank 1 foresaw the penalty not only for delayed payments but also for delayed submission of real estate insurance policy, with amount of 0.5% of the volume of gratuitous loan on the day of default on obligations (min LVL 100.00, max LVL 1,000.00), for not submitting specific information and/or documents to the bank - 0.05% (min LVL 5.00 and max LVL 500.00), as well as other defaults on obligations - 0.25% of volume of gratuitous loan but not less than LVL 100.00.

Bank 2, in turn, charges penalty of 0.16% per day from the sum of delayed credit payment for each delayed day for delayed credit payment, the same terms apply also to interest payments. The Bank also has special penalties for construction credits, if there is no compliance with laws and regulations concerning building permit, change of such personal data as name or surname of the borrower, as well as if the mortgaged real estate is not insured, the bank charges penalty of LVL 100.00. The Bank also intended to increase the interest rate from 0.25% to 1.0% if there have been delayed payments taking into account the number of days and frequency.

Bank 3 charges penalty for not submitting the required documents on time – LVL 2.00 per day.

Bank 4 charges penalty of LVL 25.00 for not submitting a new insurance policy and documents requested by bank on time, for change of residence or other personal identification data. The Bank charges additional penalty if the client repeatedly has not insured the mortgaged property – LVL 200.00, for additional terms in credit agreement 0.2% of the volume of gratuitous loan for each delayed day, but not more than 10% of the volume of gratuitous loan, as well as 10% from the amount of credit that has not been paid on 31st day, if the client has received preterm repayment request from bank.

To become responsible not only for the information that should be included in credit agreement but also for the clients, the banks have to base their activities not only on financial but also social factors, by including environmental factors in the evaluation process of credit application, as it can be seen in Table 2.

Table 2

Stages of borrower's (private person's) credit evaluation when considering new credit application

Stage	Activities to be implemented
1st	1. Loan application; 2. Obtaining of general information about the client.
2nd	1. Evaluation of client's solvency taking into account financial factors; 2. Evaluation of the offered security backing on the basis of environmental factors.
3rd	1. Drawing up of the loan proposal
4th	1. Decision making
5th	1. Signing the agreement and monitoring

As it can be seen in Table 2, the most important stage in the evaluation of a private person's solvency is the 2nd one, because not only financial threats but also environmental factors are at play. If, for example, a piece of land is used as a credit security backing, it is necessary to get information about whether there had been a factory on this land or some sort of pollution that is or could cause environmental pollution. When mortgaging a piece of land that is polluted, in the future it could cause additional expenditures for bank if it comes into possession of the land in case the client is not able to settle the debt. After stating nonconformity of one or the other factor, evaluation of solvency remains on the 2nd stage, which is followed by credit refusal.

On the basis of the performed analysis of the information included in bank loan agreements and imposed sanctions for breach of agreement terms, the authors elaborated a formula. The formula will allow calculating the amount of monthly credit payments and total expenses expected in case of any unfavourable scenario, for example, delayed credit payment, documents not submitted to the bank and other non-compliance to special terms.

$$c = \frac{D_1 + D_2 + D_3}{12} \Big/ \frac{\Pr(1+r)^n}{(1+r)^n - 1} \quad (1)$$

Where: c – proportion of total expenditure increase in monthly credit payment;
D_1 – penalty for delayed payments;
D_2 – penalty for delayed submission of insurance policy;
D_3 – other penalties;
r - the monthly interest rate, expressed as a decimal, not as a percentage. Since the quoted yearly interest rate is not a compound rate, the monthly interest rate is simply the yearly interest rate divided by 12; dividing the monthly interest rate by 100 gives r, the monthly rate expressed as a decimal;
n - the number of monthly payments, called the loan's term;
P - the amount borrowed, known as the loan principal.

CONCLUSIONS

In order to evaluate the overall situation in the Baltic States and the European Union the authors see it necessity for future research to perform analysis of laws and regulations of all European Union member states that concern responsible lending.

During the research the authors faced a restriction that bank loan agreements are not publicly available and in order to preserve confidentiality of the banks that were willing to cooperate, the authors substituted the names with labels.

The new mortgage credit offered by commercial bank that provides opportunity to settle liabilities at any time of duration of the loan agreement, transferring the mortgaged real estate into possession of the bank, can promote irresponsible borrowing because the client will be able or willing at any time, for any reason to give away his mortgaged real estate, thus causing new fluctuations of the market and decrease in real estate prices, as well as additional expenses to the bank that will occur with properties in bank's possession, similarly as it happened in the USA.

The authors consider that in Latvia regulations that strictly regulate mortgage lending issues should be introduced, because as seen considering the analysis of loan agreements, banks comply with the existing legislation. In addition to evaluation of the existing financial factors evaluation of environmental factors should be performed.

Also the authors consider that in Latvia and Estonia, similarly to Lithuania, it is necessary to set equal terms of lending for all banks, which would include the maximal allowable sum from the market value of real estate or purchase sum, average proportion of credit and interest payment against income.

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