EUROPEAN FUND FOR SOUTHEAST EUROPE
DEVELOPMENT FACILITY

A practical guide
for future home owners

BUYING A HOME WITH A MORTGAGE LOAN

Keep the decision in your own hands

Understanding the risks of long-term borrowing

About this brochure

This brochure has been written for Georgian families who are thinking of buying a house or apartment of their own to live in, and are considering whether to finance it with a long-term loan.

If you are interested in buying a house or apartment, this brochure provides you with guidance on:

- how to estimate the total cost of purchasing a home
- how to estimate how much you can afford to borrow
- the most important contract conditions with regard to currencies, interest rates, maturities and repayment schemes

The brochure also offers:

- a step-by-step guide to help you make your decision
- a checklist of questions to ask lenders before taking out a mortgage loan
- practical tips on other important aspects to bear in mind when buying a home

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Disclaimer

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Attention:

Usually people expect the value of real estate to go up, but be aware that the value can also go down.

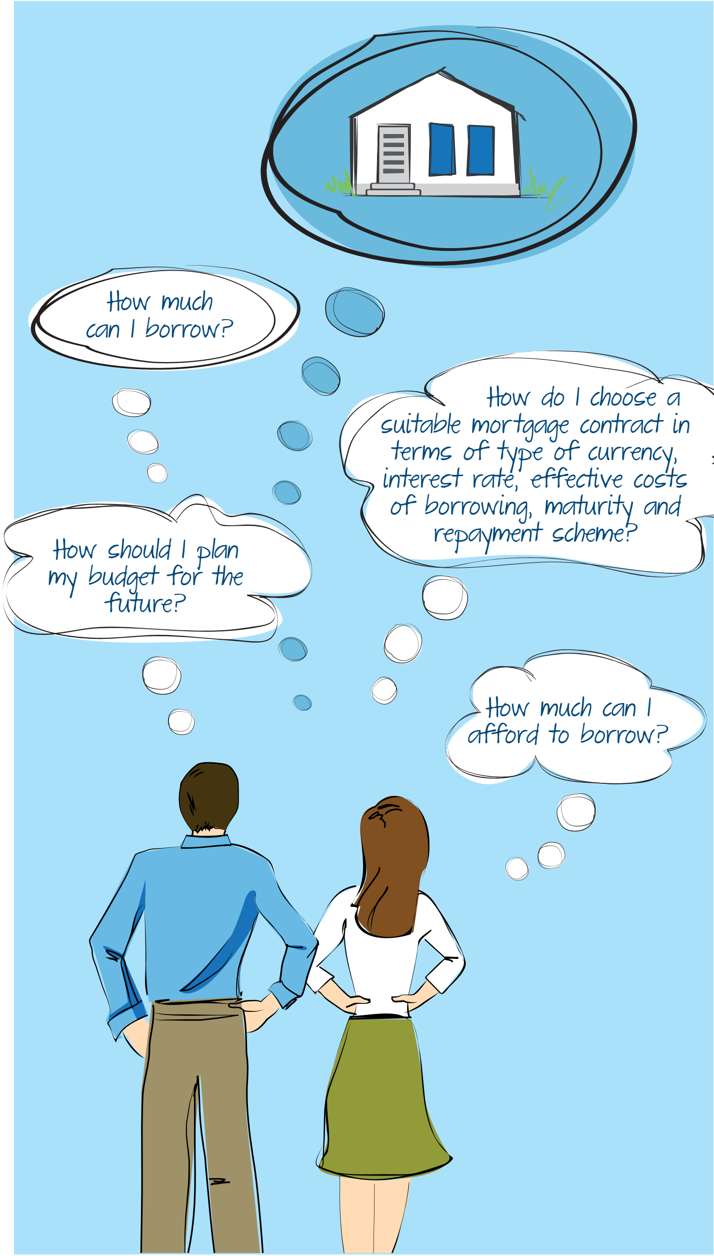
Thinking of buying a home

Purchasing a home is probably the most important investment most of us will ever make. And very probably we will need to take out a mortgage loan to do so.

Mortgage loans can be used to finance the purchase, construction or renovation of a home, with the house or apartment itself serving as collateral. Typically, mortgage loans carry lower interest rates and have longer terms than most other types of loans. They are offered in local or foreign currency.

Taking out a mortgage loan is not an easy decision and requires careful assessment beforehand. It involves a relatively large amount of money and takes a long time to pay back, and for this reason, many people understandably regard mortgage loans as being somewhat risky. After all, if your financial situation worsens during the term of the loan, you may find yourself in a situation where you are no longer able to repay it. However, with careful planning it is possible to mitigate the risks involved. People also tend to be deterred from taking out a mortgage loan by the eligibility requirements imposed by lenders, and in particular the need to finance part of the investment up front with your own funds.

This brochure is designed to help you find answers to some of the key questions you will need to address before taking out a mortgage loan:



How much can I borrow?

Mortgage loans typically do not cover the total amount of money needed to purchase a home. The maximum amount that you will be able to borrow will most likely be a certain percentage of the value of the property you wish to purchase. Lenders call this percentage the "Loan-To-Value" (LTV) ratio, and they usually set a maximum LTV ratio of 70-80%.

Banks usually take the market value of the property as the basis for calculating the LTV ratio. The market value is determined by the bank´s internal property appraiser and may include a certain discount.

Attention:

Sometimes relatives offer their homes as additional mortgage in order to increase the maximum amount you can borrow. Be aware that you put your relatives in risk of losing their home if you cannot finish repaying your loan. In fact, requirements imposed by lenders exist to protect not only the lender but also you against the risk of excessive indebtedness.

Let's have a closer look at what the LTV ratio means in practice:

Suppose that the home you want to buy has a market value of GEL 100,000. Here is a calculation of the maximum amount you can borrow, assuming that the lender has set a maximum LTV ratio of 70%.

Example:

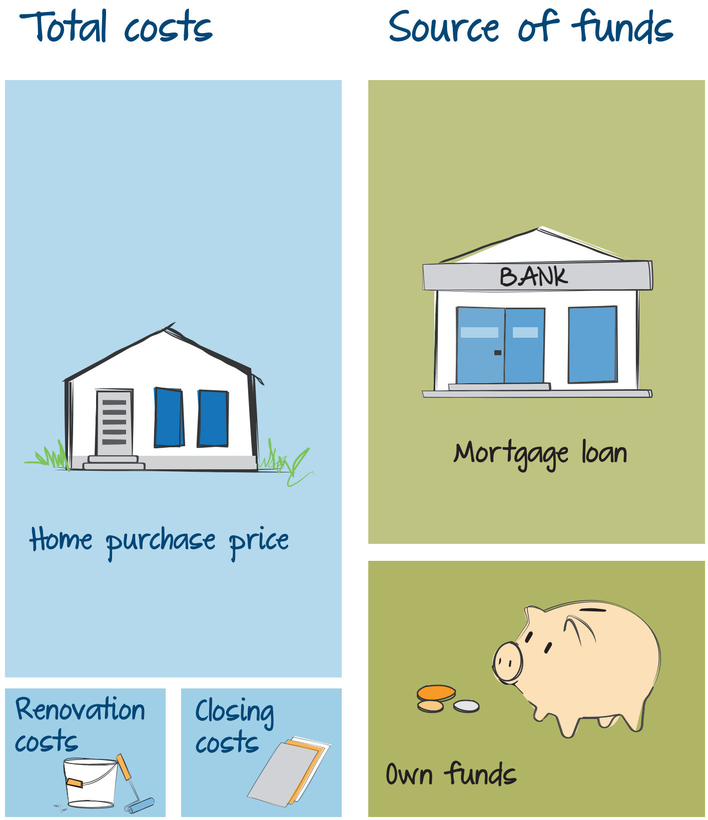
Market value of the property:		GEL 100,000
	x 70%	
Maximum loan amount:		GEL 70,000

The maximum amount you could borrow would be GEL 70,000 on a home you want to purchase at GEL 100,000. This means that you would have to cover the difference between purchase price and the maximum loan amount you can borrow with your own funds.

In fact, you will need to have even more own funds than that, because the price of the property itself is not the only cost you will have to cover. You will also have to pay for property registration, taxes and bank fees, amounting to around 2,5% of the loan amount. And depending on the condition of the home you plan to buy, you will probably need to renovate, and possibly also make structural improvements before moving in, such as upgrading the heating system, renewing the floors or replacing some or all of the windows. And of course, you will need to furnish your new home.

So the total cost of buying a home consists of the purchase price plus **closing costs** (the costs associated with completing the purchase, i.e. closing the deal) and possibly also **renovation costs** (costs incurred when making necessary upgrades and repairs).

As the maximum amount of the mortgage loan you can borrow is limited to the maximum LTV ratio, and as the total costs of buying a home always exceed the purchase price of the property, you will have to cover a substantial amount of the total costs with your own funds.



Attention:

If you're thinking of taking out an additional loan to cover the remaining costs of purchasing a home, you need to bear in mind that the interest rates on other types of loans are generally higher than on mortgage loans, and maturities tend to be shorter. This in turn usually means high monthly instalments which could stretch your monthly repayment capacity to the limit – or even beyond.

You may be deterred by the amount of your own funds that you will have to put towards financing a home. But finding enough money of your own is easier if you start to accumulate savings at an early stage. Long *before* you actually buy a home, you should start to regularly pay part of your income into a savings account, together with any financial support you may receive from family members.

How much can I afford to borrow?

Taking out a mortgage loan usually means taking on a financial commitment for many years. So you need to bear in mind that something could happen in the future that might change your financial situation. In other words, even if you can afford to pay the mortgage instalments now, you have to make sure that you will still be able to do so in the future.

Therefore it's important to choose an instalment amount that gives you space to cope with any financial challenges that might occur during the time that you're paying back the loan. In order to answer the question "how much can I afford to pay for a mortgage instalment?" you can use the table on the right to check your monthly budget.

Take your time to gather the data on your family's monthly income and expenses. Start with your take-home pay, in other words the amount of money that is actually available to you after all taxes (income tax, etc.) have been deducted from your gross salary. Then try to list everything that you spend money on, and don't forget to include occasional expenses such as birthday presents, wedding gifts, car repairs or medical treatment. Write all the numbers down in the "Current" column of the table. Add them up and enter them in the "Total expenses" row. Then subtract your total expenses from your take-home pay. The remaining balance will tell you the amount that is currently available for paying a mortgage instalment each month.

	Current monthly budget	Forecast monthly budget
Monthly take-home pay		
Food		
Utilities		
Transportation		
Clothing		
Education		
Repairs and maintenance		
Insurance (car, home, life)		
Holidays and entertainment		
Gifts		
Family support		
Medical treatment		
Credit card payments		
Consumer loan payments		
Other regular expenses (e.g. savings plans, etc.)		
Total expenses		
Monthly available income for mortgage instalment		

Good to know...

Don't forget that sudden increases in the price of food, transport, gas or electricity can put pressure on your budget.

Now, review your budget and try to make a realistic forecast of your income and expenses in the years to come. Consider how your expenses will change in the future if, for example, you start a family, send your children to university, purchase a car or make improvements to your home. Also reflect on large one-off payments for which you possibly had to take out a loan in the past and would have to do so again in the future. Think conservatively of all the possible ways in which your situation could change while you are still paying back the mortgage loan, consider how those changes would affect your income and expenses, and enter the adjusted figures in the "Forecast" column.

Subtract your forecast total monthly expenses from your forecast monthly take-home pay to calculate the amount of money you can realistically afford to pay for a mortgage instalment every month throughout the entire term of the loan.

An additional way of checking whether you can afford a mortgage loan is to **calculate your Payment-To-Income (PTI) ratio**.

$$\text{PTI ratio} = \frac{\text{Monthly total debt service payments}}{\text{Monthly take-home pay}}$$

Add up all your monthly payments for all outstanding loans, plus the instalment on the mortgage loan you plan to take out (including principal, interest, fees and insurance) to calculate your monthly total debt service payments. Then divide this by your monthly take-home pay. The recommended PTI ratio is considered to be 30%, which means that total debt service payments should not exceed 30% of your take-home pay.

Check: Is your PTI ratio at an acceptable level?

Good to know...

If you receive remittances from your family abroad, be aware that they might not be able to keep supporting you if the country they live in goes through a period of economic difficulties. Because of this risk we recommend that you **do not count remittances as part of your regular take-home pay**, but rather as additional income which can be used to cover occasional expenses, make unscheduled repayments on your loan or stock up your emergency fund.

Attention:

If you lose your job, take on additional debt, become ill or have to make a large one-off payment, such as urgent repairs to your home, it may become difficult to pay off your mortgage – unless you are prepared for it. Since you don't have a crystal ball to see into the future, we strongly recommend that you set aside an emergency fund as a risk buffer and enquire about available insurance policies to cover such risks. A rule of thumb is that this emergency fund should cover at least two monthly instalments.

How do I choose a suitable mortgage contract?

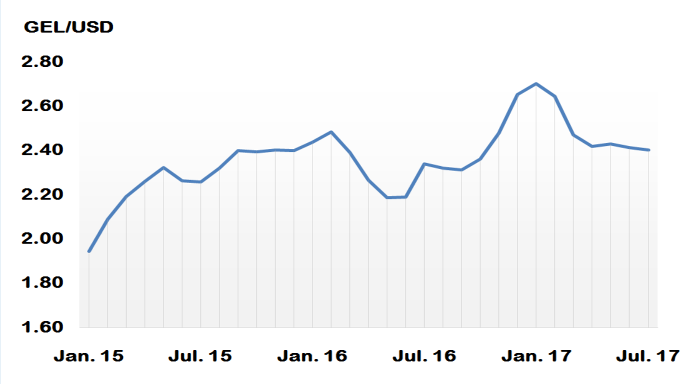
When you have worked out how much you can afford to borrow, it's time to find out which loan terms suit you best. Let's have a look at the most important contract terms that lenders may offer to you:

Should I borrow in foreign currency?

You may be offered the option of taking out a mortgage loan in foreign currency. Here are some facts that you should know about borrowing in foreign currency.

If you take out a mortgage loan in foreign currency, you will have to repay this loan in the same currency, e.g. USD. So you'll need to consider how much of your future income will be in USD. If you do not have enough USD income, you will have to exchange GEL for USD on the due date at the exchange rate set by your bank as of that date.

This means that you will be exposed to exchange rate fluctuations and have to pay conversion costs: The **exchange rate** is the price you pay for foreign currency, e.g. the value of 1 USD in GEL terms. It is impossible to foresee the development of an exchange rate. The GEL/USD exchange rate has been very volatile in recent years.



GEL/USD exchange rate 2015-2017

The development of the exchange rate is influenced by many factors that you cannot control, such as expectations and speculations in the short-term, trade balance and balance of payments as a whole in the medium-term and economic growth/performance and inflation in the long-term. A **depreciation** of the GEL means that the Georgian currency has lost value against the USD over time, which in turn means that you have to pay a higher amount in GEL for 1 USD than you did, say, a few months ago. Conversely, an **appreciation** of the GEL would mean that you would have to pay less GEL for 1 USD. Thus, each time you have to pay an instalment, the exchange rate may have changed, sometimes in your favour but sometimes to your disadvantage.

Good to know...

The more income in USD you have, the less foreign currency risk you will incur when taking out a mortgage loan in USD. But if you receive most of your disposable income in GEL, it is safer to borrow in GEL.

For example, if you have taken out a mortgage loan in USD and the GEL has depreciated, your mortgage instalment will be more expensive because you will have to convert more GEL into USD to pay for it. The possibility that you will incur additional costs for the payment of your instalment because of exchange rate fluctuations is described as **foreign currency risk**.

Example:

Imagine you are a newly married couple and you want to purchase a home of your own. You have enough money to make a down payment but you will need to take out a mortgage loan to afford the rest. Now you have to decide whether to borrow in foreign currency or local currency.

You receive all of your income in local currency, about GEL 3,000 per month. If you decide to take out the loan in USD, you will have to repay it in USD. What would happen to your budget if things turned bad and the GEL were to depreciate by 20%? Would you still be able to pay the mortgage instalment?

To answer this question, you would perform the following calculation:

Calculation:

	Monthly budget	Monthly budget after 20% GEL depreciation
Total take-home pay	3,000	3,000
Total expenses	1,800	1,800
Available amount	1,200	1,200
Mortgage instalment in GEL terms	1,000	1,200
Buffer	+200	0

Conclusion

In this example, the cost of the mortgage instalment in GEL terms increases from 1,000 to 1,200. This means that a 20% depreciation of the GEL would increase the mortgage instalment by GEL 200, which would leave you without a financial buffer.

Comparing the costs of a mortgage loan

You will notice that interest rates vary from lender to lender, not only in terms of their level but also in terms of the way they are calculated. Here are some facts that will help you to compare the different interest rates offered.

In Georgia, lenders might offer you a fixed rate mortgage or a floating rate mortgage. What are the differences?

With a **fixed rate mortgag**e, the interest rate remains the same over the life of the loan and is fixed at the beginning of the contract. In contrast, the interest rate on a **floating rate mortgage** may change over time. The floating interest rate consists of a **reference interest** rate plus a fixed additional rate set by the bank. In the case of foreign currency loans, the reference interest rate is usually linked to a floating international benchmark such as the EURIBOR (for EUR) or the LIBOR (for USD), which changes periodically. On loans in GEL, the floating interest rate usually depends on the **refinancing rate** which is established by the National Bank of Georgia at regular intervals. The current reference rates are published on the website of the National Bank of Georgia (www.nbg.gov.ge), in economic newspapers or on various other websites.

Choosing between fixed and floating interest rates can be difficult. If you have a fixed rate mortgage, you will not be harmed by rising interest rates – but you will also not be able to benefit from decreases in interest rates, as you would with a floating rate mortgage. Generally the initial interest rate on a floating rate mortgage is lower than the fixed interest rate over a comparable term. But bear in mind that your mortgage will span a long period of time. Market conditions can change significantly, impacting the level of the reference interest rate. The longer the loan term is, the greater the probability of interest rate cycles with very high and very low rates, and the more difficult it will be for you to predict future interest rate developments.

Ask the lender how the floating interest rate is calculated and make sure you understand the process and the logic behind it. Have a look at the movement of the respective reference rate over the past ten years and ask yourself whether or not you would be comfortable with such a fluctuation in interest rates and the resulting changes in your loan payments. And finally, ask yourself how important it is for you to have the security and predictability of a fixed rate mortgage.

Example:

Let's assume, for example, that you have a floating rate mortgage that is conditional on a reference rate of 4%, and a fixed additional rate of 5.5% per year. Hence, the initial interest rate amounts to 9.5% per year. Let's assume that there is a 25% increase in that reference interest rate. How does this impact the interest rate of your floating rate mortgage compared to a fixed rate mortgage with an initial interest rate of, say, 10% per year?

Good to know...

In Georgia, you normally do not have to buy insurance from the lender. Usually, you are free to compare prices offered by other insurers and choose the policy that seems most reasonable.

Bearing in mind how floating interest rates work, you can now start comparing the total costs of taking out a mortgage loan.

Lenders typically quote their **nominal annual interest rates**. However, the nominal interest rate does not include all costs related to a loan, and these additional costs can vary significantly from lender to lender.

In addition to the nominal interest rate, the following costs may apply when taking out a loan:

- disbursement fee
- account management fee
- cash withdrawal fee
- property insurance fee
- late payment penalty and interest, if applicable
- prepayment penalty, if applicable
- life insurance

In some cases, the fees are paid only once, e.g. at loan disbursement, while other fees are payable at regular intervals and are typically included in the monthly repayments on your mortgage loan.

Calculation:

	Interest rate per year at loan disbursement	Interest rate per year after 25% increase in the reference rate
Fixed rate mortgage	10%	10%
Floating rate mortgage	4% + 5.5% = 9.5%	(4%*1,25) + 5.5% = 5% + 5.5% = 10.5%

Whereas the interest rate of the fixed rate mortgage remains the same all the time, a 25% increase in the base rate underlying the floating rate mortgage would increase the interest rate to 10.5% per year.

Good to know...

Ask your bank whether it is possible to make early repayments. You may be fortunate enough to obtain a large amount of money or your salary may be increased in the future, which would enable you to pay back part of the loan earlier than planned, or even pay off the debt in full. Such unscheduled repayments can, however, come at a cost for you, as the bank might charge you a penalty (prepayment fees) to compensate for the interest income it forgoes.

Some lenders offer lower nominal interest rates but charge higher fees than others. This can mean that the actual cost of the loan is substantially higher than it might appear at first glance, possibly offsetting the advantage of lower nominal interest rates. Therefore, instead of comparing the nominal interest rates offered by lenders you should compare the **total costs** related to a loan, i.e. the nominal interest rate plus all other costs related to the loan.

To make it easier for you to compare the total costs of the loan you can ask your bank to calculate the effective annual interest rate. **The effective annual interest rate includes the nominal annual interest rate plus all other fees (as percentage of the loan amount) charged directly by the lender and therefore is to base your comparison on**.

Choosing the right repayment scheme

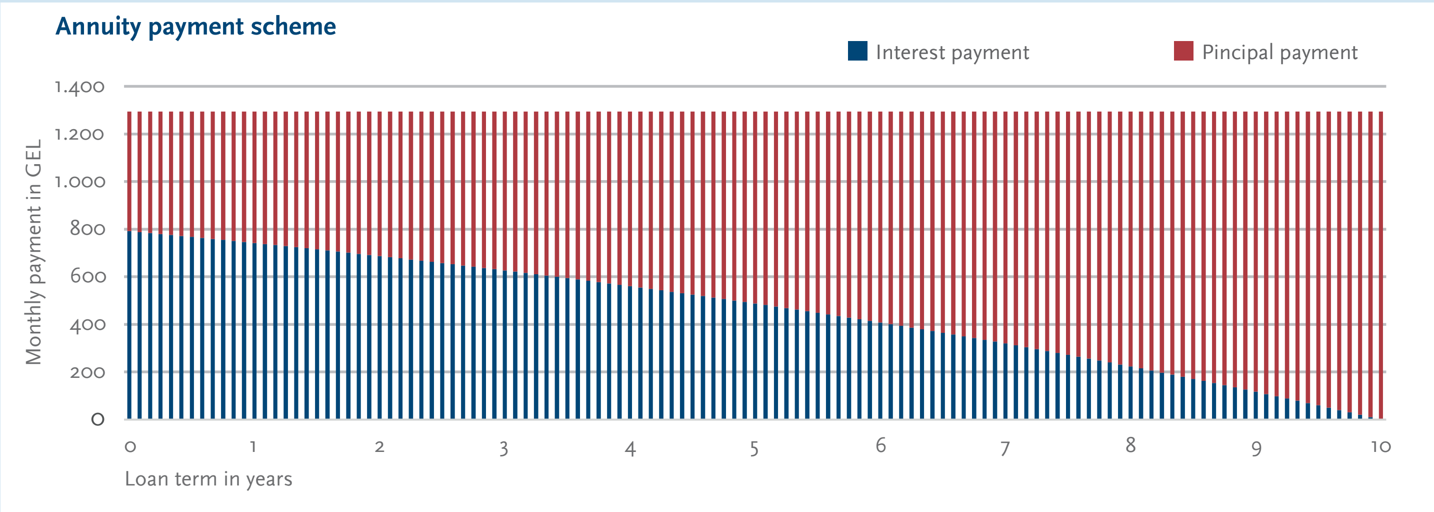
Most lenders in Georgia will offer you a mortgage loan with a maturity of up to 15 years for the purchase or construction of a home. You can generally choose between two different types of repayment schemes: annuity payments or equal payments.

To better understand the differences between the two repayment schemes, let's have a closer look at an example based on a mortgage loan of GEL 100,000 with a 9.5% nominal interest rate per year and a term of 10 years disbursed in January 2015.

With **annuity payments** the total amount of the payment is fixed over the whole life of the loan and is usually paid on a monthly basis. Each month, the interest payment is calculated based on the outstanding loan amount. Initially the monthly payment will consist of more interest and less principal. As the term progresses and principal is repaid, there is less principal outstanding to pay interest on. Therefore, the amount of interest charged will decrease and more of the monthly payment will be made up by principal at the end of the loan. In our example, the monthly payment (excluding fees) amounts to GEL 1,294 and the effective interest rate is 9.93% per year. This payment scheme is most commonly used by lenders worldwide.

As it is the case with the annuity payment scheme, nominal interest should be charged on the outstanding loan amount. In Georgia, however, lenders also offer a so-called **equal payment scheme**. With this scheme, in stark contrast to the annuity payment scheme, the nominal interest for each payment is charged on the total initially disbursed loan amount instead of the outstanding loan amount. Although with each payment there is less principal outstanding, the interest payment stays fixed over the whole life of the loan. This way of calculating the interest makes the cost of your loan significantly higher than with an annuity payment scheme. In our example, with an equal payment scheme your monthly payment (excluding fees) would amount to GEL 1,625 and results in an effective interest rate of 16.30% per year!

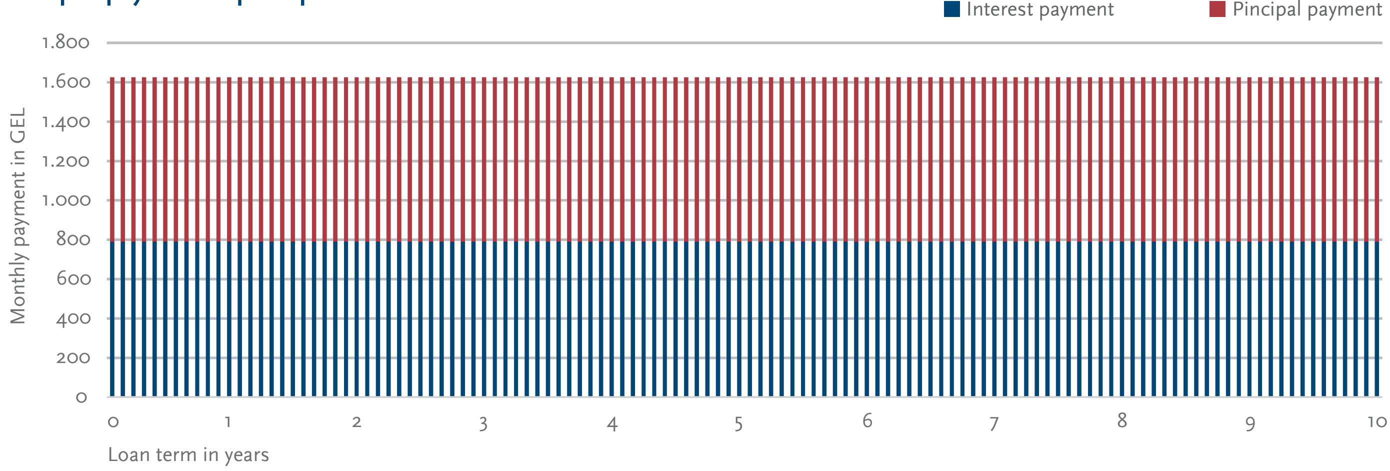
Given the same loan conditions and terms, **the total interest cost with an equal payment scheme is considerably higher than with an annuity scheme**. In other words, if both loans have the same nominal annual interest rate and maturity, the equal payment scheme will always have a significantly higher effective annual interest rate. Make sure you check the repayment conditions offered when requesting loan offers from lenders and **do not take loans with an equal payment scheme as described above**.



Attention:

Some lenders also offer **bullet repayment loans**. During the term of the loan you only pay interest on the total loan amount, while the total loan amount is due at the end of the term. Please consider when taking bullet repayment mortgage loans that a) this type of mortgage loan incurs high interest costs since interest is charged over the total disbursed loan amount for the whole loan term and b) since all principal is repaid at once, you would need to have the total amount of money received at loan disbursement at hand the day the loan payment is due.

Equal payment of principal and interest scheme



Calculating the effective interest rate:

Visit the consumer´s protection website of the National Bank of Georgia in order to calculate for yourself the effective interest rate of different loan offers.

http://nbg.gov.ge/cp/index.php?m=549&lng=eng

Once you have requested loan offers from different lenders you can insert the loan amount, the payment frequency, the number of payments and the payment amount as stated in the payment plan in the calculator. The tool will calculate the effective interest rate for you. In order to make the effective interest rate calculator a useful tool for comparison of different loan terms, make sure the payment amount includes all fees charged by the lender.

Decision making step-by-step

By reading this brochure you have learned many important aspects that you need to consider when taking out a mortgage loan. Let's have a look at the way these aspects are interrelated and the implications for your decision making.

Find an appropriate property that will meet your needs for the next 15 years.

Check if your own funds cover at least 30% of the purchase price *and* the costs for closing the deal and renovation. 30%

See page 4

yes

no

Look for a less expensive home.

Accumulate more savings.

Check if your future monthly available income is sufficient to cover instalments.

See page 6

yes

no

Request at least two offers for mortgage loans.

Make sure you understand the terms and conditions offered.

- Choose between a loan in local or foreign currency *See page 8/9*
- Choose between a floating or fixed rate mortgage *See page 10/11*
- Choose the repayment scheme *See page 12/13*
- Compare the total costs related to the loan *See page 13*

Compare the offers and choose the one that best suits your future budget.

Don't forget to ask your lender

Finally, we believe that your lender should not only offer you loans but should also provide you with useful advice. Make sure you understand the terms and conditions, and all the related risks, before signing the contract. Below you will find a list of important questions that you should ask your lender before taking out a mortgage loan.

Basic terms and conditions

- ☐ What is the maximum Loan-To-Value (LTV) ratio?
- ☐ Which currencies is the mortgage loan available in?
- ☐ What is the maximum Payment-To-Income (PTI) ratio?
- ☐ What are the available maturities for loans in local and foreign currency?
- ☐ Can I change the currency of the loan during the term of the loan?

Interest rates

- ☐ What type of interest rates are available for mortgage loans in local/foreign currency?
- ☐ How long will the interest rate be fixed?
- ☐ What is the reference interest rate on which floating rate mortgages are based?
- ☐ How often is the reference interest rate expected to change? How did the reference rate develop in the past ten years?
- ☐ Is the lender allowed to change the reference rate during the term of the loan?
- ☐ Can I switch from a fixed rate mortgage to a floating rate mortgage and vice versa during the loan term?

Repayment of the loan

- ☐ What will happen if I'm temporarily unable to repay the loan?
- ☐ Are early (partial or full) repayments of the mortgage loan possible? Is there a penalty fee?
- ☐ What is the penalty for late payments?

Costs of the loan

- ☐ What is the effective annual interest rate for the chosen loan term? Which of the costs related to the loan are included in the monthly instalments and which ones are paid separately?
- ☐ What are the costs of property insurance?
- ☐ How much is the disbursement fee? What are the costs for property registration?

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Careful planning of your finances and a solid understanding of the implications of long-term borrowing are essential when buying a home with a mortgage loan. We are confident that the information in this booklet, coupled with the support you receive from your lender, will help you choose a home that suits not only your needs but also your finances!

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