Developing the Russian Housing Finance System

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Readily available housing finance is a critical element in the reform of the housing sector and the national economy in Russia. Housing investment has traditionally been an important component of capital investment: in 1990 housing constituted 15 percent of total investment. During the period of economic transition, housing investment has been down sharply: the completion of housing (measured in square metres - the standard measure in the USSR) in 1991 was down 32 percent from 1989; and in 1992 production was about half of the 1989 level.[1] Further reductions are in prospect because housing has been largely eliminated from the central budget, the former primary source of state investment; local governments are not able to replace these funds because of their own budgetary difficulties. Similarly, many enterprises are cutting their orders for new housing in response to the economic slump.

The housing situation in Russia is legendary for its shortages. The better estimates suggest that 40 percent of households in urban areas are living in overcrowded conditions (Kosareva, 1992). While some of this shortfall could be met by a more efficient allocation of the available stock, massive shortages would still remain.[2]

At the same time, surging inflation during 1992 wiped out the savings of many households who have been unable to find savings instruments to preserve the value of their wealth (CIS Statistics Committee, 1992, Table 5). Hence, only a small share of families have the ability to purchase a unit without a loan. Free, or nearly free of charge privatisation of state rental housing has created nearly three million families who could generate a large downpayment through sale of their newly acquired unit; but most of them would also likely need a loan to purchase a new unit.[3]

Under these conditions, increasing the effective demand for new construction through long-term mortgage lending is clearly necessary. Additionally, spurring the demand for housing would help reduce the money balances in circulation: consumers are now using their rubles to chase the limited supply of goods which can act as a store of wealth.

Expanding long-term housing lending in Russia is a challenging task. The situation can be characterised simply as follows: while there has been limited housing lending, lending in which the housing asset serves formally as collateral did not exist until the passage of the Law on Collateral in May 1992; the banking system is embryonic and the creation of over 1,500 new commercial banks in the past two years has resulted in a poorly supervised and probably fragile system;[4] high and volatile inflation rates (about 25 percent per month in the first quarter of 1993) imply potentially great interest rate risk for long-term lending, since the banking system's liabilities are heavily concentrated in short-term accounts; and, there is potentially grave credit risk associated with housing lending because of the current confusion about the legal basis for eviction of an occupant from his unit.

This paper discusses the steps that the Russian Federation has taken to address the fundamental problems of long-term housing (or mortgage) lending implied in the previous paragraph. It begins with a brief overview of long term housing lending as it existed at the beginning of the transition period, which we mark for convenience as the beginning of 1992. The second section describes the actions taken by both the Government of Russia and the Supreme Soviet of the Russian Federation and the initiatives of individual lenders. The third section reports on the concrete plans of several banks. The fourth section assesses the actions of governments and lenders from the perspective of their impact on

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reducing the various types of risk which lenders face in making long-term housing loans. The final section provides some brief conclusions.

TRADITIONAL HOUSING LENDING

Traditional long-term housing lending in the Soviet Union was quite simple and can be characterised by the following four points:

- Loan volume each year was determined in the centrally-developed economic plan. Beginning in 1988, all long-term housing lending was done by the State Savings Bank, also known as Sberbank, which was changed into a joint stock bank in 1991.[5]
- Lending was for individual construction and housing cooperatives.[6] Since individual construction was forbidden since 1961 in cities of over 100,000 population, only cooperative loans occurred in these places; and individual loans were concentrated in smaller cities and rural areas.[7]
- Housing loans were not explicitly secured by the property as collateral, and eviction in the case of default was questionable. In practice, lenders protected themselves by typically having loan payments deducted from wages by employers; where this was not possible, guarantors were sought and the bank could have wages garnished for non-payment. Sberbank experienced low levels of delinquencies.[8]
- The loan instrument is a fixed rate loan; interest rates were low and loan periods long.

Basic information on the lending of the past few years is given in Tables 1 and 2. We focus here on events through 1991; developments in 1992 are discussed in the next section. The data in Table 1 show that loans to individuals can be characterised as having extraordinarily long terms and carrying very low interest rates. These loans carried subsidies: the 2 percent interest

Table 1: Housing Loan Terms in the Russian Federation, 1988 - 1992

	1988	1989	1990	1991	1992	1993 (April)
Loans to individuals[e]						
interest rate	2	2	2	3	8 (+12)[a]	g
loan term (years)	50	50	50	25	20	
maximum LTV	75	75	75	75	75	
maximum loan (th. rub.)	20	20	20	20	-	
Loans to cooperatives (HBC)[d]						
interest rate	.5	.5	.5	3	8 (+12)[a]	g
loan term (years)	25	25	25	25	20	
maximum LTV[b]	70	70	70	70	70	
GDP Deflator, 1988 = 100[i]	100	103	114	246	4,084	h
Interest on 1 year time deposit (%)	3	3	3	5	30[c]	100[f]

Source: Sberbank

Notes:

a. Beginning in April 1992 individual or cooperatives paid 8% and 12% was subsidised by the state budget. For the period January 10 to April 1, 1992, the interest rate on loans to individuals was 15%.
b. LTV was determined through special decrees of the Soviet government. Some regions, e.g. Siberian coal areas, had and still have LTV's of 80%.
c. Since August 1, 1992. For the period January 1 to August 1, 1992, the interest rate was 10%.
d. House Building Cooperative.
e. Loans for construction of individual houses.
f. Since April 1, 1993; from January 1, 1993, the rate was 60%. Beginning in January, the interest paid on deposits was being compounded; previously no compounding had occurred.
g. In early April 1993, future loan terms were being determined by the bank.
h. Data not available. Monthly increases in consumer prices for January - March are widely quoted as 25%.
i. Source: Ministry of Economy, Center for Economic Forecasting.

rate charged until 1991 was less than the bank's cost of one-year time deposits and only 100 basis points above the official inflation rate. In 1991, the loan rate was 200 basis points below the one-year time deposit rate. Maximum loan amounts were reasonable compared with the cost of housing.

Lending for units constructed for Housing Building Cooperatives (HBC) carried deeper interest rate subsidies - the interest rate on these loans being only 0.5 percent. The loan term was shorter than on individual loans, but at 25 years, still long enough to permit low monthly payments.

Even in 1990, loan interest rates were negative in real terms. By 1991 they were sharply negative, setting the stage for even worse conditions in 1992.

As shown in Table 2, the good news for Sberbank is that its volume of long term lending for housing has been small, and in recent years it has fallen in real terms. There are several ways to make the point about the small loan volume. In 1991, the number of loans to individuals was the equivalent to about 0.2 percent of the 1990 housing stock, and 0.8 percent of the 1990 single family housing stock.[9] Similarly, such lending constituted only 0.2 to 0.4 percent of Gross Domestic Product.

Table 2: Long - Term Lending for Housing in the Russian Federation, 1988 - 1992

	1988	1989	1990	1991	1992 (9 mo)
Loans to individuals					
number (thousands)	73.4	53.1	124.4	94.8	c
volume [a]	661	438	1,296	2,127	10,138
average loan size [b]	8.9	8.2	10.4	22.4	c
Loans to cooperatives					
volume [a]	574	502	468	648	1,293
Total volume [a]					
current prices	1,235	940	1,763	2,775	11,431
1988 prices	1,235	912	1,682	1,191	382
Ratio: loan volume to GDP as percent	.32	.16	.28	.23	.14

Source: Sberbank

Notes:
a. millions of rubles, current prices
b. thousands of rubles, current prices
c. data not available

There is no question that housing lending in the Russian Federation has been low compared with other countries. The figures in Table 3 document that among middle-income countries, the Russian Federation had an extremely low ratio of mortgage loans to total housing investment. This, of course, is largely attributable to the enormous role played by direct state investment in the production of new rental housing. But even compared with Poland and Hungary, the Russian figure is tiny.

DEVELOPMENTS IN 1992 AND 1993

The Russian government took several steps in 1992 and 1993 to establish the legal foundation for real mortgage lending. At the same time it began subsidising housing lending in highly undesirable ways. Meanwhile, there were notable developments in the private banking community, including Sberbank. Most recently, the Government has drafted a significant plan for the development of housing finance.

Legal Developments

A very important development was the passage in May by the Supreme Soviet of the Law on Collateral. While addressing collateralised lending in general, it implicitly includes property and land among the items that can serve as collateral. More specifically, land is included only if there is a mortgageable structure on it; otherwise land mortgages are still governed by the RSFSR Land Code. The law on Collateral also permits the mortgaging of land rights with the consent of the owner - an important feature in Russia where sales of municipally owned land in urban areas has been highly restricted and most land has been conveyed through leasehold. The amendment to Article 12 of the constitution by the Seventh Congress of Peoples' Deputies is likely to make clear ownership of residential land for individual construction more common.[10]

The law on collateral makes clear the power of the mortgagee to sell the collateral securing the loan to satisfy his just claims, and the procedures for foreclosure are specified in the Code of Civil Procedures (Butler, 1992). These provisions for mortgage lending are being refined in the Law on Mortgage which is under preparation in the Supreme Soviet.

Western lawyers who have reviewed the Law on Collateral believe that it offers a serviceable basis for mortgage lending. They also believe that the law could be significantly strengthened by careful crafting of the provisions of the Law on Mortgage (Butler, 1992). Nevertheless, two major problems may continue to exist after the passage of the Law on Mortgage. First, the housing code, based on constitutional provisions, forbids eviction of households from state rental dwelling units without the provision of comparable substitute housing.[11] When a foreclosure is presented to the courts, it is not certain how the courts will react, despite the fact that the laws on collateral and mortgage, and the civil code all explicitly allow foreclosure, and if necessary, eviction (Butler, 1992a). In fact, under the civil code, the court is given considerable discretion in delaying foreclosure proceeding.

Table 3: Ratio of Mortgage Loans to Total Investment for Housing: Selected Middle Income Countries[a]

Eastern Europe	
Poland	.33
Hungary	.41
Russian Fed.[b]	.07
Other	
Thailand	.66
Morocco	.25
Jamaica	.28
Korea	.62
Colombia	.60
Malaysia	.73
Mexico	.77
Turkey	.07
Brazil	.21
Chile	.44
Jordan	.34
Philippines	.58
Tunisia	.20
Venezuela	.24

Source: World Bank Housing Indicators Project, and authors' calculations for the Russian Federation.

Notes:
a. Data are generally for 1990.
b. Long-term housing loans, not mortgages.

Second, registration of land, properties and mortgages may pose a problem, at least in the short term. The law on mortgage details the contents of the mortgage registration. The problem, however, is in the creation of an operational system. Laws passed by the Supreme Soviet in the past two years on land and property mandate the creation of the necessary systems.[12] Administrative decrees mandate the creation of reliable cadastre.[13] However, the regulations implementing the registration systems have not been promulgated by the Council of Ministers. Until registration is in effect, at least outside of the cities, lenders may face very substantial uncertainty about the ownership of properties and land proposed as collateral. On the other hand, it must be noted that some cities, including Moscow, have moved fairly aggressively to implement registration systems; and some cities have already issued local regulations requiring the registration of mortgages.

Deep Subsidies

In the first half of 1992, the government displayed a distinct tendency to address the problem of reduced purchasing power of would-be purchasers of new residential units through subsidies, combined with continued use of the fixed rate mortgage. The subsidies were believed to be necessary to offset increases in house prices and interest rates associated with inflation: subsidies were to help sustain housing affordability. As far as we can determine, limited, if any, analysis of the full cost of such subsidies was made prior to the decision to implement the programs.

Two cases illustrate this proclivity on the part of Government. First, under Presidential Decree No. 140, households purchasing a unit through a housing cooperative which began construction before January 1992, receive grants covering 70 percent of the increase in unit costs and interest rate increases. The subsidies are shared equally between the Federation and lower levels of government. Second, under an agreement among the Ministry of Finance, the Central Bank, and Sberbank effective the first of April, Sberbank committed to lending 30 percent of incremental liabilities for farm development and individual and cooperative housing at a 20 percent interest rate. Of the 20 percent, only 8 percent is paid by the borrower and 12 percent is paid from the Federation budget. While these loans were profitable to Sberbank in the spring of 1992, the bank estimates its 1993 cost of funds at 63 percent; hence, it will suffer large losses on all of these loans.

In April 1993, Sberbank was considering how much to increase its mortgage interest rate,[14] and was negotiating with the Ministry of Finance about the size of the government interest rate subsidy. Interest rates will likely be over 100 percent, with some share of it financed by the budget. Such a simple increase in the interest rate while retaining the fixed rate instrument has two problems: (a) it is likely to offer the bank only a temporary respite from negative spreads on its loans as the cost of money is likely to continue to rise; and (b) the higher interest rate to the borrower will have sharply deleterious effects on the size of the loan for which a borrower can qualify. A more permanent solution will require changing to some form of indexed loan instrument.[15]

In neither of the two programs just described are there income, unit size or other restrictions on eligibility. Indeed, a rich Muscovite who had received a free of charge unit through privatisation would qualify for the loans being made by Sberbank.

A real concern about these governmental actions is that they indicate that the government was responding to pressure by well-connected groups in making its funding decisions rather than having a thought-out strategy of its own. Moreover, the subsidies may have little effect on the willingness of banks to make long-term housing loans unless the risks inherent in such lending are reduced to manageable levels (see below).

Private Initiatives

Given the extraordinarily difficult conditions for long-term mortgage lending in Russia, bankers have displayed a surprising interest in exploring the possibility of such lending. Indeed, several new institutions with "mortgage bank" in their names have been created. Despite these hopeful signs, we are aware of no long-term lending for housing besides that done by Sberbank.

New Mortgage Banks

An unknown number of "mortgage banks" were registered in the Russian Federation in 1992. Here we report on three banks that we investigated, two in Moscow and one in St. Petersburg.

The *St. Petersburg Mortgage Bank* was selected because it had received a good deal of attention from the press.[16] The bank, established in February 1992, has five founders, which include a commercial bank, a government agency, and three enterprises, among them a joint venture between Russian and British firms. Together they have paid in something over one-half of the rub 100 million authorised capital. As of the end of November it had not made any long-term loans, nor has it made loans yet to individuals for home purchase. Reasons cited for reluctance included problems with the eviction of borrowers in case of foreclosure, and the high duties for notarising property transfers. It has only made two short-term commercial loans in which a property explicitly serves as collateral.[17]

The *Joint-Stock Mortgage Bank*, located in Moscow, was registered only on December 24, 1992, and began operations in January 1993. Its principal share holders are five commercial banks, and other founders include an insurance company and some commercial firms in Moscow.[18] In terms of paid-in capital, the bank is among the largest 15 percent of all banks in Russia. The bank will concentrate initially on commercial loans, some of which will be secured by real estate (and, therefore, will be labelled "mortgage loans"). The bank has a strong interest in originating long-term mortgage loans but no immediate plans to begin such operations. Funds mobilisation plans were under development at the time of writing.

Sberbank has been active in the creation of another new mortgage bank - the *Mortgage Standard Bank*. The bank was being registered in the first quarter of 1993, with its principal equity holders being Sberbank and Industrial Commercial AvtoVAZbank. Total paid-in capital from these and other founders is rub 200 million. The parent banks would be the main source of funds, at least for the first couple of years. Plans are for the mortgage bank to begin long-term housing lending as soon as it becomes operational. In the first phase of such lending, loans will be made to employees of enterprises which establish a special relationship with the bank; this relationship will extend both to the enterprise keeping some funds on deposit and those working with the bank to structure lending programs that are affordable to its employees and which entail a low credit risk to the bank. The bank plans to use some form of an indexed mortgage instrument for its lending.

Beyond the actual developments in 1992 and 1993, several banks prepared concrete plans for the realisation of mortgage lending. Some of these are briefly described below.

Contract Savings at Sberbank

Sberbank proposes establishing a subsidiary which would engage in long-term housing lending using the savings of future borrowers as the source of funds. The system would be a "closed system" patterned on the Bausparkassen systems of Germany and Austria. The principal difference between the Teutonic system and the one proposed for Russia is caused by the inflationary environment in which the Russian scheme would operate. The scheme designed by Sberbank is complicated, relying on a series of subsidies during the savings period to maintain the real value of the savings and potentially large interest rate subsidies during the borrowing period to further enhance affordability. The main benefit of the system is that it would mobilise household funds for use in the housing sector; from a macro-economic perspective anything that increases the savings rate is clearly helpful.

A recent analysis has computed the present value of the subsidies involved in this scheme. Ravicz (1992) concludes that the program would provide savers a large measure of protection against inflation, but the cost of doing so is high. The subsidy as a share of savings would range from 41 to 60 percent for a family with an income of rub 20,000. The family's subsidy as a share of its combined savings plus loan would drop somewhat to 24 to 54 percent. Nevertheless, a family with this income would still only be able to afford about 60 percent of the cost of a modest unit at the end of 8 years, if they could afford to devote 25 percent of their income to savings and mortgage payments. Similar results, but somewhat lower *percentage* subsidy levels, were obtained for higher income families; they would, however, be easily able to afford the modest home.

In sum, Ravicz concludes that the subsidies are high and not well targeted. Furthermore, enterprises, as well as the state, will be required to bear this burden. Given the precarious financial condition of many firms, it appears ill-advised to further handicap them with mandatory subsidies to employees. Despite critics of the program, housing-linked contract savings schemes were included in the draft Presidential Decree on "Development and Implementation of Non Budget Forms of Investment in the Housing Sector" as one vehicle the government would subsidise to promote housing construction.[19] In early April, the proposal was withdrawn by Sberbank, however, on the ground that the scheme is unworkable under current inflationary conditions.

Mosbusinessbank

In December, Mosbusinessbank (MBB), one of the largest and financially strongest commercial banks, announced that it would begin mortgage lending, possibly through the formation of a subsidiary mortgage bank. Included in the announcement was the conclusion of an agreement with the U.S. Agency for International Development under which MBB will receive very substantial assistance with the creation of the lending operations during 1993. Macroeconomic conditions permitting, the target date for beginning lending is January 1994.

MAKING MORTGAGE LENDING FEASIBLE: REDUCING AND ALLOCATING RISK EFFICIENTLY

Making long-term mortgage loans involves several risks. In Russia, with its volatile economic conditions and the questions surrounding eviction and foreclosure, most risks are higher than in the West for "structural" reasons. These risks can be reduced significantly - and often at low cost - by appropriate action by the national government. Additionally, lenders have the ability to mitigate some of these risks, particularly interest rate and credit risks, through adopting proper practices. This section begins by discussing three types of risk, and how the government could help address them. It then looks at the actions that the Government and banks have taken to date in this sphere.

Possible Actions to Reduce Risk

(1) Interest Rate Risk

Interest rate risk is the risk that the cost of funds to the lender will rise relative to the interest rate on outstanding loans, thereby causing the lender to lose money on the loans. This risk increases as the difference in the duration (or effective term) of the mortgages and the liabilities funding them increases. Possible government actions include:

- grant affirmative permission and encourage use of indexed mortgage instruments that are suitable to inflation prone economies.
- make necessary changes in computation of tax liability because of deferred receipt of interest income due.
- develop reliable indexes for use with these instruments, indexes in which the public will have confidence.

The Price-Level Adjusted Mortgage, the Dual Index Mortgage, the Bulgarian Indexed Capped Credit and similar loan instrument designs were developed to work in countries with high or volatile inflation. They increase the size of the loan the borrower can take with a specified share of his income, by lowering the interest rate initially paid to 5-10 percent; the full interest rate payments are captured later because the loan principal is indexed to inflation or a cost-of-funds index. Thus, these instruments shift some of the increased interest payments required on the loan into the future when the borrower will better be able to pay them because his income will be higher. Equally important, these instruments shift most or all of the interest rate risk away from the lender onto the borrower.[20]

(2) Intermediation / Liquidity Risk

Intermediation risk is the risk that depositors will withdraw their funds at a time inconvenient for the bank. Liquidity risk is the risk that the bank will experience a comparatively small inflow of funds, including loan repayments, compared with the demands of depositors for funds, including interest payments due.

- encourage the State Pension Fund and other government funds to purchase mortgage-backed securities at market prices.

Pension funds and insurance companies typically have a large volume of investable funds. In addition, their needs for cash can be quite accurately predicted on a year-to-year basis. For this reason they have a comparative advantage in making long-term investments. Mortgages, in general, are such an investment. Securities backed by negative amortising mortgages will likely be attractive to investors who can afford to hold them to maturity. At the same time, there are few good investment instruments in Russian financial markets. Price or interest rate-indexed bonds or other securities based on pools of mortgages should, therefore, be highly attractive investments. One policy could be to give pension funds and insurance companies a target for their holding of mortgage investments, perhaps to reach 5 percent of investments over a several year period.[21]

- establish a liquidity facility to purchase indexed mortgage instruments (e.g., PLAMs and BICCs) at market interest rates.

A characteristic of the indexed loans is that they defer some of the payments due early in the life of the loan to later years when the borrower, whose income will have risen, will be in a better position to make the larger payments. Because of the deferral of the payments, the loan balance increases. The deferred payments mean that in the early years of the loan the bank has less funds with which to pay interest on deposits and to make payments to those who want to withdraw their deposits. Hence, it could experience some liquidity difficulty. Such difficulties will only occur, however, to banks that are holding a sizeable share (perhaps over

30 percent) of their assets in these types of loans.

Under this proposal, the Central Bank or Ministry of Finance would establish a facility that would consider requests from banks originating indexed mortgage loans for the facility to purchase the securities explicitly collateralised by these mortgages. In this way, major mortgage lenders could resolve their liquidity problem. The facility would base its decision to purchase the mortgage-backed securities offered to it in part on the share of all assets constituted by the indexed mortgages.[22]

It would be desirable for macroeconomic policy for the facility not to purchase these funds exclusively with Central Bank or government funds. The expansion in the supply of money could be controlled by the facility, in turn, selling securities to the public. The securities sold by the facility could be based on pools of mortgages from several banks (or securities bought from these banks which provide funds to the facility from the mortgage payments and repayments of principal).

(3) Credit Risk

This is the risk that the borrower will not repay the loan, and/or that the bank will not be permitted to foreclose on the loan.

- establish a reliable registration system for land, property, and mortgage and other liens on land and property to reduce lenders risk from clouded titles.

- establish the ability for the lender to foreclose; create an expedited system in the courts for hearing real estate cases including default on housing loans.

Clearly, the necessity for the ability to foreclose a loan and evict the borrower in default is fundamental to collateralised lending. The Ministry of justice could join in the first few foreclosure cases brought to the courts, and it should monitor the execution of the court orders by the bailiff to ensure that a strong precedent is established. The special system of courts will help ensure that foreclosure is a reality and that real estate cases are heard by judges knowledgeable in the field. In addition to making foreclosure a reality, Government and banks can determine the types of lending procedures that have been effective in other countries in which foreclosure is difficult or impossible, but lenders have successfully dealt with credit risk. India offers a prominent example of a highly successful, high volume mortgage lender operating in a hostile legal environment by having excellent underwriting and loan servicing practices.[23]

Actions to Date

In the past few months, the Russian Federation and private banks have taken a number of actions to improve the feasibility of mortgage lending, by reducing the risks involved in such lending. The actions are reviewed below, following the classification of risks employed above.

(1) Interest Rate Risk

There has been substantial interest and activity by Sberbank and Mosbusinessbank in the structuring of an indexed instrument for use in Russia. The result has been the creation of the Deferred Adjustable Instrument for Russia - DAIR. While the DAIR is based on Bulgarian Indexed Capped Credit (BICC), the design issues for the Russian instrument turned out to differ markedly from those in other Eastern European countries because of the combination in Russia of rampant inflation and a banking system with an interest rate structure massively negative in real terms. (In the first quarter of 1993, inflation was running at well over 1,500 percent annually, while the inter-bank lending rate, a market-determined rate, was about 125 percent per year.) Interest rates have, however, been rising relative to inflation.

The DAIR, like the BICC, employs two interest rates: (a) a "payment rate," i.e., the rate of interest used to compute what the borrower pays each month (typically in the range of 5-10 percent); and (b) a "contract rate," which is used to compute what the borrower owes. The contract rate for the DAIR is the inter-bank lending rate plus additional charges for various risks, administration, and profit. The difference between the amount owed and the amount paid each month is added to the loan balance. Payments due are recalculated quarterly using the new loan balance, and the amortisation period is reduced each quarter to force the loan to close on time.[24]

Under the conditions existing in Russia, it is not feasible to require the new mortgage to have a positive real rate of return. One obstacle is that the Central Bank is unlikely to permit such high rates in one sector. Rather, the objective is to have the rate of return competitive with other opportunities available to the bank; operationally, this is taken to be the inter-bank lending rate. Hence, the measure of profitability is relative to the bank making a series of short term loans (the whole period being equivalent to the mortgage loan period) in the inter-bank market. The DAIR, as designed, would yield about 140 percent of the inter-bank rate, and should be extremely safe in terms of credit risk (see below). Critically, the DAIR is flexible enough to work under a variety of inflation-interest rates regimes that could develop during the transition period.

The adoption of indexed instruments is encouraged in the draft Presidential Decree that seeks to stimulate housing construction and mortgage lending.[25] In particular, the decree would require the germane federal agencies to prepare the necessary regulations on indexed instruments, including addressing the special accounting and taxation issues raised by such instruments. The same agencies are to develop the cost of funds index(es) necessary for the actual implementation of such instruments.

(2) Intermediation / Liquidity risk

The draft Presidential Decree moves on two fronts to address these risks. First, it would create the Agency for Mortgage Lending, which will act as a liquidity facility, with the ability to purchase mortgages from originators. The Agency will also control the quality of mortgage-backed securities issued by banks. Second, the decree would mandate that a specified share of the funds of the State Pension Fund and the State Insurance Company be invested in mortgage-backed securities: a minimum of 1 percent in 1993 and 5 percent in 1995, assuming a sufficient volume of approved securities is available.

(3) Credit Risk

Beyond the provisions in the Laws on Collateral and Mortgage, several additional actions have been taken that either have or will ultimately reduce credit risk. These actions can be organised into two groups.

First, the U.S. Agency for International Development is sponsoring the work of experts with a major commercial bank to introduce strong underwriting and loan servicing procedures. Over time, ways will be sought to promulgate these procedures to other banks.

Second, the Presidential Decree on financing housing construction would make the Agency for Mortgage Lending responsible for creation of insurance for mortgage lenders against loan default.

Lastly, we should note the impact on credit risk of the extremely high inflation rates combined with use of the inter-bank lending rate as the main element in pricing indexed mortgages. With the inter-bank rate running at less than 10 percent of the inflation rate, it is clear that even if borrower incomes increase at only 60-75 percent of inflation, the ratio of mortgage payments to income will decline very sharply over time. Indeed, the simulations for the DAIR with a 1,500 percent annual inflation rate indicate that under conservative assumptions on income growth the ratio of mortgage payments to borrower's income falls from 30 percent at origination to about 5 percent in fifteen months. In short, the particular combination of conditions in the Russian Federation have sharply reduced credit risk.

CONCLUSIONS

The foregoing discussion makes clear the embryonic state of mortgage financing in the Russian Federation. It is extremely difficult to forecast the pace of future development because so much depends on the government: both in arresting the dangerous rates of inflation and in establishing the broad conditions under which mortgage lending can be undertaken on terms protecting both the lender and the borrower.

In this context, it is doubly surprising to see banks apparently ready to begin long-term mortgage lending. There is, of course, extreme pressure to do so by local as well as the Federation government in order to save existing construction firms from bankruptcy, and thereby maintain employment levels. As mortgage lending begins, it appears that it will be characterised by use of indexed mortgage instruments; there is some chance Sberbank will shift to an indexed instrument for its lending. Adoption of these instruments will greatly increase the size of loan families can take under current market conditions and will reduce the need for government subsidies to enhance affordability. Whether the government will act on this and restrict subsidies is unclear.

Still, most of the positive developments are as yet prospective. As of mid-April 1993, no bank has adopted an indexed mortgage instrument; the pivotal Presidential Decree described above has not been issued. In reality little has happened. This quite gloomy picture is quite consistent with the experience elsewhere in Eastern Europe, where reform of the typically much more developed housing finance systems has been slow.[26] On the other hand, one can take some encouragement from the presence in the Government and in the banking system, of individuals who understand what needs to be done. Converting this conceptual strength into action will take some time, but some real action may be seen in 1993. ■

NOTES

1 Data from Gostroi (1993).

2 Struyk et al. (1993) estimate that about 5 percent of the renter households in Moscow occupied more square metres of housing than a reasonable social norm. Such "over consumption" is expected where rents are extremely low, and there is no incentive for households to shift to smaller units when household size declines.

3 See Kosareva and Struyk (forthcoming) for a description of this program.

4 International Monetary Fund et al. (1991), vol.2, Chapter IV.5.

5 Before this, loans to individuals were made by Gosbank and Stroibank. Loans to members of cooperatives were made by Zhilsots Bank and Stroibank.

6 There are two types of cooperatives: housing building cooperatives (HBC) and housing cooperatives (HC). For HBCs the borrower is the cooperative who on-lends to individual households. For HCs individual members obtain loans to purchase the units from a seller - municipal government or an enterprise. See Andrusz. (1991) for a thorough discussion of housing cooperatives in the USSR.

7 In reality, housing cooperatives were highly concentrated in Moscow and St. Petersburg.

8 As of the end of l991, Sberbank's cumulative delinquent payments were rub 6.4 million on a housing loan volume of rub 10 billion. Source: interview with M.A. Gavrilin and A.K. Abramova, August 12, 1992.

9 Data on the 1990 stock are from the State Committee on Statistics of the RSFS (1991).

[10] The applicability of the revised article 12 is unsettled at this time. Some lawyers are arguing that it applies only to rural land; others take the position that it applies to urban land.

[11] This will be changed in the new codex that will implement the law on the Fundamentals of Federal Housing Policy, passed in December 1992. The law states that housing of the standard of "hostels" must be provided.

[12] The legal concept of residential real estate was introduced through the city planning law in mid-1992. This concept was strengthened by the passage of the basic housing reform law, "On the Fundamentals of the Federal Housing Policy."

[13] Enactment #622, "On Perfection of Management of the State Land Cadastre in the Russian Federation", issued by the Premier of the Russian Federation, August 25, 1992.

[14] Sberbank shifted to a mortgage contract for its long term housing lending after the passage of the Law on Collateral.

[15] Some options are discussed below.

[16] This description is based on material developed by Olga Kaganova in a meeting with the president of the bank, Mr. Vorobyev, and various written documents provided to her by Mr. Vorobyev.

[17] The bank's main housing-related activity is organising the purchase of units in inner-city buildings now containing communal flats. Purchasers of the units in the to-be-rehabilitated building make payment to the bank in advance for their unit. The bank helps obtain rights to the property, assists in arranging for sitting tenants to be relocated to new flats, and provides a construction period loan for the rehabilitation of the property.

[18] Information based on an interview with Arkady Ivanov, President of the bank.

[19] Other aspects of this Decree are discussed below.

[20] These instruments are described in detail in Telgarsky and Mark (1991) and Ravicz (1992a).

[21] These funds should, however, be discouraged from becoming mortgage loan originators, either directly or through subsidiaries. Rather, they should invest in mortgage-backed securities.

[22] It is simpler for the facility to purchase mortgages or participations in full mortgages, rather than to purchase securities based only on the negative amortisation (so-called "strips", i.e., stripping some of the income from the mortgage from the main part). The objective of the program - to provide increased liquidity - would be realised under either option. But investors would more easily understand investments based on full mortgages.

[23] A description of the procedures followed by the most successful Indian mortgage lender, the Housing Development Finance Corporation, is in Buckley et al. (1985). Mortgage insurance would also be useful, but it would have to be structured to encourage careful underwriting. Creating such insurance probably should be deferred until a later stage of development of the housing finance system.

[24] The BICC is described in Ravicz (1992a) and the DAIR in Ravicz (1993).

[25] The decree is titled, "On the Development and Implementation of Non Budget Forms of Investment in the Housing Sector. It was approved in principle at the cabinet meeting of March 16. Its specific provisions are still being determined.

[26] See Baross and Struyk.

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Deregulation is blamed by some for the turmoil in financial markets in the past few years, but this is not the general view. Deregulation, when badly done, as in America, has been disastrous. When well done, as in Britain, it has facilitated a smooth transition from a market which had become inappropriate in a modern economy to one that will serve nations well in the 21st century. Deregulation is here to stay. Those who talk about regulation generally confuse regulation with supervision. It should be automatic that deregulation goes hand in hand with tougher capital requirements and a more intrusive supervisory system. In the case of British building societies this was done at the outset. In other countries the lesson is being learned the hard way.

The barriers between markets and institutions will increasingly erode. Specialist housing finance lenders are likely to go out of business one way or another. Some may change their form such that they become more general banking institutions regulated in the same way as other banks. Others, particularly those which are subsidiaries of banks, may be absorbed into the parent bank, and some will change their status into general banking institutions. Housing finance will be seen as one part of a wide range of retail financial services. Much of the business will be conducted by wide ranging banking institutions, but there will always be room for specialists, concentrating on housing finance and doing it efficiently.

In developing countries it is vital to continue to develop a sound institutional framework and to build on the experience of successful institutions. The market potential is huge. ■

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infrastructure services. However, the actual amount of land compensation reflects the economic value of acquired land.

[2] The model is based on a project with the following characteristics: site area of 50,000 square metres; a pre-redevelopment constructed area of 40,000 square metres (an FAR of 0.8); and 1,086 housing units within a total residential constructed area of 38,000 square metres (approximately 35 square metres per unit). It also contained 2,000 square metres of public facilities. The post-redevelopment simulation (baseline case) assumes that the site is redeveloped to an FAR of 2.0 and contains 100,000 square metres of constructed space. Reflecting practices in many cities, the simulation assumes that all households are resettled on site and that each household receives an average of 50 square metres of constructed area for a total area of 54,300 square metres. Additional public facilities are constructed to reach 5,000 square metres. After these allocations are made, there is an additional 40,700 square metres of commodity space. Total average construction costs (both hard and soft costs) are assumed to average Yuan 1,000 per square metre. ■