Emerging Long-term Housing Finance in Russia

by Nadezhda B. Kosareva and Raymond J. Struyk

Traditionally the Soviet system of housing finance corresponded to the basic characteristics of the whole policy in the housing sector—the centralized distribution of the budget funds for construction of state rental housing and its free-of-charge allocation to those who meet official standards for needing improvement in their living conditions. As a result, in 1987 the share of state capital investments in housing construction amounted to more than 80%, and the share of individuals was just 14.6% (including the finances of individual housing construction and construction of housing cooperatives).[1]

By 1994 the share of investment in housing construction from the federal budget amounted only to about 5%, with a major part allocated to financing housing for retired military officers.[2] In 1994 the share of all state investments (funded from the federal budget, budgets of subjects of federation and funds of state enterprises) amounted to 22.7%, while investments of private individuals reached 28.6%. Private corporations accounted for most of the balance.

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Since the state budget was always the main source for financing housing construction, supplemented only by some contributions from enterprise funds, the mechanisms for the public to participate in resolving its own housing problem in Russia were practically nonexistent. Even the financing that did exist was directed at constructing new housing by individuals or cooperatives, not at purchasing of existing housing. This can be explained by the very small individual housing market in the preceding period, a market limited by numerous restrictions. Thus, to fill the gap in housing investment created by the dramatic cut in budget funds, Russia needs to attract funds from the population and banks must act as intermediaries in ways unimaginable even in 1990.

This article briefly reviews long-term housing finance under the Soviet system and the shifts to development since the beginning of the transition. The basic conclusion is that despite a highly adverse economic situation and shaky legal basis for collateralized lending, Russia's numerous new commercial banks have been creative in developing long-term housing loan products.

LENDING UNDER THE OLD REGIME AND THE EARLY TRANSITION

Before the economic reform there was no mortgage financing system, in the normal sense of the term, in existence in Russia. Housing loans were not explicitly secured by the property as collateral before 1992, when the "Law on Collateral" was adopted, and eviction in the case of default was questionable. In practice, lenders protected themselves typically by 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.

Under the Soviet system long-term financing of housing for the population had been the function of one or two state banks. After 1988, the only bank offering such loans was the Russian Saving Bank (Sberbank), which became a joint-stock commercial bank in 1991, wholly controlled by the state (the majority of shares belong to the Central Bank of Russia). Sberbank is the only joint-stock commercial bank in the country where the depositors' money is protected by the state.

Long-term financing for housing offered by Sberbank was to three basic groups and purposes:

1. Individual citizens for single-family homes (construction, reconstruction and rehabilitation).
2. Housing construction cooperatives (for construction).
3. Individual citizens for garden cottages and seasonal houses in the country (building, purchase, repair).

The bulk of financial resources went toward financing new housing construction. Table 1

Table 1. Housing Finance by Sberbank

	1988	1989	1990	1991	1992	1993	1994
	Loans for Individuals for Housing Construction						
Number of loans originated, in thousands	73.4	53.1	124.4	98.4	120.1	101.3	–*
Volume of loans originated (bln current rubles)	.6	.4	1.3	21.6	200.2	217.0	
Loan term, in years	50	50	50	25	20	10	10
Interest rate, %	2	2	2	3	8 (+12)[a]	100–210[b]	210–140[b]
Maximum LTV	75	75	75	75	75	70	70
	Loans to Housing Construction Cooperatives						
Volume of loans originated (mln current rubles)	574	502	468	648	3805	18089	none
Loan term, in years	25	25	25	25	20	10	10
Interest rate, %	0.5	0.5	0.5	3	8 (+12)[c]	100–210[d]	210–140[d]
Maximum LTV	70	70	70	70	70	70	70
Interest on 1-year time deposit (%)	3	3	3	5	30[c]	120[d]	110[e]

* No data available

[a] Beginning in April 1992 individuals or cooperatives paid 8% and 12% were subsidized by the state budget. For the period of January 10 to April 1, 1992, the interest rate on loans to individuals was 15%.

[b] Beginning in 1993 and till October 1994, the interest rate on adjustable rate loans was changing with the Central Bank discount rate; from October 12, 1994, it was set at 140% (lower than the discount rate that was 170%) and it is still the same now (April 1995).

[c] For the period January 1 to August 1, 1992, the interest rate was 10 %.

[d] Beginning in January 1, 1993, the rate was 60 %. By the end of the year higher rates were being paid on larger deposits. Rates on balances under R100,000 were 120%; the maximum rate of 180% on balances over R5 million.

[e] Data as of April 1995: The interest rate, 110% on balances under R100,000; the maximum rate of 130% paid on all balances over R5 million. The exchange rate in April 1995 was about 5000 rubles = $1.

Source: *Sberbank of the Russian Federation*

shows data on two types of financing in 1988-94. It should be noted that, before 1993, only fixed-rate loans were offered in the Russian housing finance system and only thereafter did Sberbank shift to adjustable rate loans.

The priority of state financing in housing has been in new construction. Thus, for example, starting in April 1992, Sberbank offered loans for the construction of individual and cooperative housing with an interest rate of 20% (12 % paid out of the federal budget).[3] A loan to purchase an existing single-family dwelling involved up to 75% of the price of the home and an interest rate on a 15-year mortgage set at market levels which could be no less than the Central Bank rate of 80%. In 1993 and until August of 1994 the interest rate for housing purchase was always higher than for the construction loans; after that they were equalized.

Loan volume was small. In 1991, the number of outstanding loans to individuals was the equivalent to about 0.2% of the units in the 1990 housing stock, and 0.8% of the 1990 single family housing stock. Similarly, such lending constituted only 0.2% to 0.4% of gross domestic product. Only 7% of all investment in housing was covered by housing loans.

The state policy of subsidizing housing construction was characterized not only by direct budget expenditures on state housing construction but also by indirect subsidies on loan interest rates. Sberbank granted such loans mainly to certain groups of the population, which, in accordance with the legislation and numerous resolutions of the government, enjoyed the right to obtain favorable or free of interest loans to construct the housing, such as World War II and Afghanistan war participants and disabled veterans, the Chernobyl catastrophe victims, retired military officers, forced migrants and refugees, victims of political reprisals and members of their family, etc.

The data in Table 1 show that loans to individuals can be characterized as having extraordinarily long terms and carrying very low interest rates. These loans carried subsidies: the 2% interest 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 Construction Cooperative carried deeper interest rate subsidies—the interest rate on these loans being only 5%.

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 and early 1993.

Initial reaction by government to the soaring inflation set off in 1992 was to attempt to sustain the old system. After 1991 when Sberbank became a commercial bank, favorable and free-of-interest loans were subsidized from the federal budget. Under an agreement between Sberbank, the Ministry of Finance of Russia and the Central Bank of Russia (April 1992), 12% of the 20% per annum interest rate was covered by the budget. The subsidies were believed necessary to offset increases in house prices and interest rates associated with inflation. Simultaneously, under Presidential Decree N.140 households purchasing a unit through a housing cooperative which began construction before January 1992 received grants covering 70% of the increase in construction costs and interest rate increases. The subsidies are shared equally between the Federation and lower levels of government.

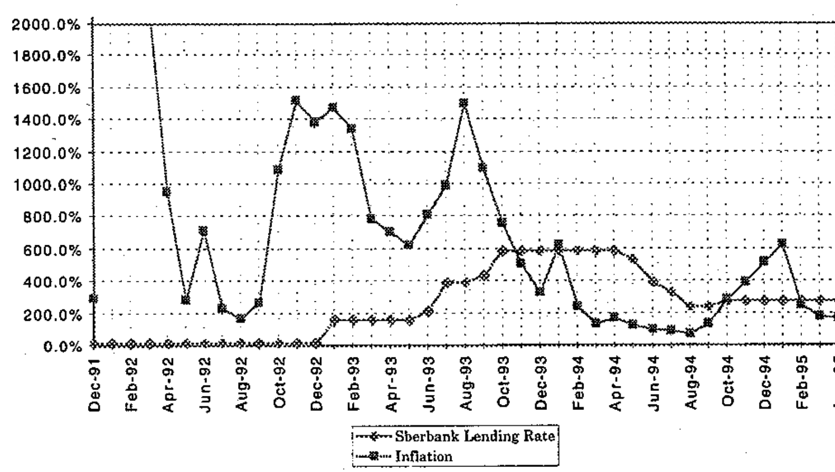
As far as we can determine, limited, if any, analysis of the full cost of such subsidies was made prior to the decision to implement the programs. The subsidies in both of the programs just described are poorly targeted. There are no income, unit size or other restrictions on eligibility. Indeed, a rich Muscovite who had received a free-of-charge unit through privatization would qualify for the loans being made by Sberbank.

By the beginning of 1993, due to the high rate of inflation, the cost of funds to Sberbank increased (interest rate on one-year deposits was 60%) and all outstanding loans were resulting in major losses. Under another agreement between the Sberbank of Russia and the Ministry of Finance of the RF (April 1993), a new credit policy was launched, and it had the practical (and dramatic) effect of stopping housing lending by the Sberbank.

In order to avoid interest rate risk, Sberbank's policy was started to grant housing loans at an adjustable interest rate equal to the discount rate of the Central Bank. Though a rate change on outstanding loans does not strictly depend on any index, it is possible when the rate of the Central Bank changes for Sberbank to make adjustments as well. The Ministry of Finance of Russia, in its turn, entered into a commitment to subsidize the interest rate on outstanding favorable and interest free loans up to the level of the Central Bank discount rate. With interest rates being extremely high, these liabilities became a burden for the budget of Russia. Hence, it was nearly impossible to grant new favorable and free-of-interest loans, and further lending was terminated by the joint decision of Sberbank of Russia and the Ministry of Finance.[4]

From the beginning of 1992 and until the end of 1993, bank interest rates were negative in real terms (see Figure 1), though not as negative as it might seem upon comparison with the nominal interest rate. The point is that

Figure 1. Inflation and Sberbank Interest Rate on Housing Loans, 1992–1995



Inflation: Monthly rate of growth of Consumer Price Index
Sberbank lending rate: Effective interest rate for individual constructions
Source: Goskomstat of Russia. Sberbank.

interest on housing loans is paid monthly or quarterly and the amount of interest rate for a given period is calculated, roughly speaking, by dividing the annual nominal interest by the number of payments in a year and compounding the monthly values. (In practice the calculation technique is slightly different.) For example if the amount of nominal annual interest on the loan in the beginning of 1993 was 100% and payments were to be made monthly, the effective interest rate calculated on a monthly compounded base equaled 161% (compared with an inflation rate at the same period equal to 600% annually).

Under the higher interest rates on the housing loans, the decrease in a number of loans for individual housing construction originated in 1993 was not very substantial. But the higher rate had a negative impact on the loans to the housing construction cooperatives, the members of which were traditionally in the middle income group. In 1994 when the nominal rate reached 210–140% and the effective interest rate became positive in real terms, their affordability became very low; and the origination of such loans practically stopped.

As for the monthly income, which determines the affordability of the Sberbank housing loan, in 1994 under 140% annual interest rate and a loan term of 10 years for construction of an individual residential house with an average price of 52.5 mln rubles (data from Goskomstat of Russia) and a downpayment of 30%, the required income is 14.3 mln rubles per month. In accordance with the estimate of Goskomstat of Russia in December 1994, the per capita monetary income equaled 348,000 rubles per month; that is, the income of the average family was 1.04 mln rubles. Thus, the amount of income, at which the Sberbank loan for individual housing construction was affordable, exceeded the average amount of family income by 14 times, i.e., it was unaffordable for the majority of the population.

The ratio of dwelling price to income has fallen considerably during the period of 1991–1994.[5] In 1991 in Moscow, when the process of price liberalization and establishment of the housing market had not yet started and the cases of purchasing housing units were few, the ratio of average house prices to average income equaled 120. But it then fell at a considerable rate during the next years: 46 in 1992, 24 in 1993 and 10 in December 1994. As to the similar ratio of housing construction costs in Moscow, its dynamics were more stable: 1.1 in 1991; 5 in 1992; 4.5 in 1993; and the same in December 1994.

Thus, summarizing the foregoing, one may state that the situation in housing finance in 1992–1993 on the eve of the government introducing of a new strategy and commercial banks searching for their place in this sector may be characterized by the following basic features:

1. rather limited amounts of budget resources, which might be used to support the housing sector, and extremely ineffective use of subsidies;
2. high and volatile inflation rates imply great interest rate risk for long-term lending, since the banking system's liabilities are heavily concentrated in short-term accounts;
3. there is possibly grave credit risk associated with housing lending because the current confusion about the enforceability of foreclosure in case of default, notwithstanding existing legal provisions; and
4. extremely low housing affordability as well as strongly negative real (regarding the level of inflation) deposit interest rates, which make it impossible for the basic groups of inhabitants of average income to purchase housing for cash or to accumulate the funds for home purchase.

MOVING TO THE MARKET

The factors just enumerated have determined the direction of the new government policy in the housing financing sphere, i.e., the necessity of designing a new legislative basis for the development of long-term housing lending, and the activities of banks in testing the acceptance of the general public to mortgage lending for construction and purchase of housing.

The new concept of housing financing policy, which was almost entirely formulated in the state targeted program "Zchilische" (summer 1993) and was assumed as the basis in a whole number of legislative and normative documents (1992–1994), consisted in the following:

1. formation of a market system of long-term mortgage lending, which should lower the risk of such bank operations, and increase of the affordability of loans for the general public; the use of mortgage instruments as the way of insuring loan repayments; creation of conditions for introducing foreclosure and using it in cases when a borrower fails to fulfill his obligations; and introduction of alternative lending instruments which can be used under the conditions of high and variable inflation;
2. transfer from subsidizing interest payments to a more effective system of targeted support of groups of lower and middle income households in the form of up-front subsidies for construction and purchase of housing;
3. providing other groups, who have not accumulated necessary savings and do not enjoy the right to receive a subsidy, with the ability to accumulate funds necessary for purchase or construction of housing or for making downpayments on mortgage loans.

Here it should be noted that not all these objectives have been realized thus far, either from the legislative and regulatory point of view, or from the point of view of their implementation in practice. The developments, however, are considerable.

Legislative Base

The problem of foreclosure and eviction in the case of loan default remains the central problem. The basic principles of collateral relations were formulated by the provisions of the Law "On Collateral" with their further elaboration in provisions of the new Civil Code of the Russian Federation, part 1 (October 1994). These documents provide the possibility to foreclose in case of a loan default. However, the right for possible eviction of a borrower's family from a residential premise is extremely limited by the effective housing legislation (The Housing Code of the RSFSR; The Civil Code of the RF, part 1, article 292), which traditionally provides citizens with extremely broad rights of using residential premises and in fact does not allow the eviction of a borrower and his family from a housing unit in case of loan default even today.

By May 1995 the State Duma had almost completed the draft of the Law "On Mortgage (Pledge of Real Estate)," which will perhaps supply a compromise settlement of this problem, though the idea of "the rights of citizens for housing" is very popular among the deputies and the elaborators of the drafters of the Law.

In December 1993 and in June 1994 two Decrees of the President of the RF were adopted, which established the basic institutional framework and regulation principles for mortgage lending.[6] The decrees provide for:

1. providing housing loans to legal entities and natural persons on a commercial basis, while the subsidies are granted only to the persons who are on the waiting-list for improved housing;
2. the housing loans may be provided for the acquisition and improvement of a land plot for housing construction, for construction and rehabilitation of housing, and for the purchase of housing;
3. the loan is secured by mortgage by the borrower of the real estate, guarantees on the loan provided by enterprises and organizations are encouraged, and other forms of guarantees are possible;
4. in a general case, the loan-to-value ratio may not exceed 70%;
5. it is clearly emphasized that use of the loan instruments with adjustable interest rate, indexation of the loan principal and deferred payments of the borrower are possible;
6. the necessity to establish the Federal Agency for Mortgage Lending, which would set the standards for residential mortgage lending, to act as a liquidity facility for mortgage lenders and to have the power to issue mortgage-backed securities to generate funds;
7. to attract public savings to housing construction and to protect savings from erosion by inflation, development of a system of targeted personal savings accounts and creation of a new form of securities—including so-called "housing certificates."

The importance of these normative documents is not that they created some new legal possibilities for the lenders, but rather the clear definition they provide for the banking sector of the new principles of housing lending, supported and promoted by the government. In view of the fact that along with the Central Bank of Russia the government and President still play an important role in the regulation of banking activity, these normative acts were of great importance for the creation of the mortgage lending market in Russia.

Following the Presidential Decree in December 1993, the Russian Federation also made a sharp change in its policy for supporting unit purchase by replacing interest rate subsidies with downpayment subsidies.[7] Subsidies can only go to those on the waiting list for housing and range from 5% to 70% of the price of the unit meeting the social norm (size) for the household, with larger subsidies going to families with lower incomes and more years on the waiting list. The objective of the subsidy is to assist moderate income families purchase a unit; the designers recognized that lower income groups would in general have to rely upon being allocated a municipal flat and that higher income households could fend for themselves.

As far as we know, in 1994 the federal budget had no special appropriations for the up-front subsidies for the construction and purchase of housing (with the exception of an experimental program in an oblast described below), though the regions were granted the right to use the state funds allocated for housing construction for the financing of such subsidies. The federal budget for 1995 allocates 350 bln. rubles (10% of the total budget for housing construction from the federal budget) for up-front subsidies to specified groups of persons on the waiting list who are eligible for a subsidy granted at the expense of the federal budget (migrants from the Far North regions, victims of the Chernobyl catastrophe, forced migrants, and the persons having the right to beneficial financing of construction and purchase of housing).

An experiment on granting such subsidies to retired military officers at the expense of the federal budget is currently carried out in the Nizhny Novgorod oblast, and the results are most impressive. From the 4000 families on the waiting list for housing in the Nizhny Novgorod oblast, during October-November the subsidies were granted to about 750 families, out of which by April 1995 about 540 families had already either bought new dwellings or had concluded an agreement for completion of construction for a unit which had previously been started but halted after being at least 70% completed. Part of the families acquired housing using both the subsidy (75%-85% of the price of social-standard housing) and their personal savings. Some families, in accordance with their credit rating, were given long-term loans by the banks implementing the program.

Other regions (e.g., in Moscow and St. Petersburg) plan to commence providing such upfront subsidies in 1995 to all groups of persons on the waiting list at the expense of the budgets of the respective subjects of the Russian Federation.

Initial Long-term Lending

Despite all the problems, there has been a substantial amount of progress in initiating mortgage lending. Banks' interest in beginning such operations appears to be driven by two factors. First is the perception of an enormous future market for mortgage loans, with the present being the time to attain a good position for future market share. The second is pressure from the federation and regional governments to support housing construction for both countercyclical economic reasons and as a way to help address the nation's severe housing problems. In effect, lenders have been finding ways, sometimes with the assistance of the government, to cope with the various risks (credit risk, interest rate risk), and a few have actually begun lending operations in 1993 and 1994.

The Mortgage Standard Bank (Moscow) was one of the first to originate, in the middle of 1993, long-term mortgage loans for housing to employees of large enterprises (KAMAZ, "Yava" tobacco factory). In May 1994 Mosbusinessbank, the third largest commercial bank in Russia in terms of assets, started the origination of long-term mortgage loans for the purchase of housing on a commercial basis to its employees. In 1994 one of the largest banks, "Menatep," granted about $2 million in loans for the purchase of housing to its employees and the general public, and is currently originating approximately 10 loans per month.

The results of a March 1995 phone survey of Moscow firms involved in the process of "sale of housing on an instalment plan" (which in fact consists of granting a long-term bank loan for the purchase of housing) found that more than 300 such loans are being made in Moscow every month.[8]

On August 12, 1993, the Association of Russian Mortgage Banks was organized. It is registered with the City of Moscow as a public, i.e., nonprofit, organization having education and other trade association objectives. The Association's creation came at the initiative of the Joint Stock Mortgage Bank and the St. Petersburg Mortgage Bank. There were 17 founding members, among them 10 banks. The banks include eight commercial banks with "mortgage" in their name. These banks are located in Moscow (two), Ufa, St. Petersburg, Rostov on Don, Kuban, Saratov and Novosibirsk. Some new banks are joining the Association constantly.

The Association is an active participant in the legislative process. Perhaps most important is the development of its training function in cooperation with a USAID-funded program, executed by the Urban Institute and Fannie Mae. Given the lack of experience with mortgage lending in Russia, the availability of high-quality training is essential to development of a sound industry.

As was noted above, the market in Russia did try to adapt to the inflationary economic conditions and unfavorable legislation by finding its own means of lowering different types of risks involved in long-term lending and increasing the affordability of loans to the people so that they could borrow enough funds to make a significant contribution to purchasing the unit. Let us consider the four main directions along which innovation has occurred.

Interest rate risk. The most difficult twin problems faced by banks are protecting the profitability of lending from severe interest rate risk (because of the decidedly short-term structure of its liabilities) while at the same time making loans affordable to borrowers.

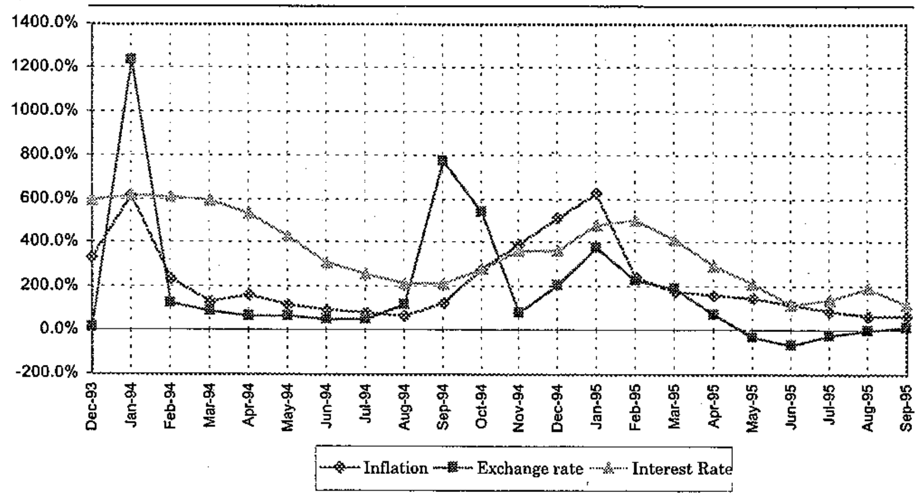
Banks making mortgage loans are addressing interest rate risk through new loan instruments: Sberbank has shifted to a variable-rate mortgage, with the interest rate defined as the Central Bank discount rate; Mosbusinessbank has adopted the DAIR, which uses the interbank lending rate as base for the index of loan principal as its measure of cost of funds; and the Nizhni Novgorod Kredit Bank and Joint-Stock Mortgage Bank in Jaroslavl have implemented an instrument which indexes the loan principal with an index based on the official minimum monthly income.

The dollar-denominated loans have become the most widespread instruments. Under these, all the loan terms are defined on the basis of a loan in US dollars with a fixed interest rate, but the borrower makes regular payments in rubles at the current exchange rate. Results of the telephone survey noted above show that Moscow commercial banks mainly use this type of loan (Stolichny Saving Bank, Alpha Bank, "Neftyanoy" Bank, Menatep, etc.).

Through employing different indexes, banks are attempting to match changes in the price of bank liabilities to changes in interest rates on originated loans. Meanwhile, considering absence of official information on the market interest rates, banks are trying to interpret these standards in a public-friendly way. But such approximations cannot fully prevent interest rate risk, since USD exchange rate fluctuations and, even more, the discrete political decisions on changing the minimum wage value do not coincide with changes of the market interest rates (see Figure 2).

Banks originating dollar-denominated loans are trying to protect themselves from interest rate risk by assigning high interest charges (30%–35% annually). It means that banks are charging the loan interest in hard currency plus interest equal to the index of the USD exchange rate. Such a high real interest rate gives banks a large cushion to absorb losses

Figure 2. Inflation, Interest Rate and Exchange Rate in Russia, 1993–1995



Inflation: Monthly rate of growth of Consumer Price Index at annual
Exchange rate: Monthly rate of growth of USD exchange rate at annual
Interest rate: Effective interbank lending rate in Moscow
Source: Goskomstat of Russia. Central Bank of Russia; Russian Economic Trends, Monthly Updates.

from mismatches between movements in the exchange rate and interest rates.

In May 1994 Mosbusinessbank began to originate loans using the procedure called Deferred Adjustable Instrument for Russia—DAIR.[9] This dual-rate mortgage instrument stipulates a cost-of-funds index, enabling the shift of most or all of the interest rate risk away from the lender to the borrower. The DAIR 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%); and (b) a "contract rate," which is used to compute what the borrower owes. The contract rate for the DAIR could be, for example, the interbank 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 amortization period is reduced each quarter to force the loan to close on time.

The objective in designing the DAIR was to have the rate of return competitive with other opportunities available to the bank; operationally this was taken to be the interbank 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 highly competitive interbank market. The DAIR, as designed, would yield about 140% of the interbank rate, and it appears to carry a quite acceptable credit risk.

By late fall 1995 bank acceptance of the DAIR had been limited mostly, we believe, because of worries about consumer acceptance. Several banks had used the instrument, however. The greatest opportunity for employing it appears to be when banks are working with large enterprises to provide loans to employees. If enterprise management accepts the instrument, employees agree as well. Future acceptability is an open question. If the government continues the strong ruble stabilization policy initiated in July 1995, which has virtually frozen the exchange rate and thereby made dollar denominated loans distinctly unprofitable, then the shift to the DAIR could happen quickly.

Loan affordability. Indexed instruments used by banks make it possible to reduce original annual interest down to 5%–10% (DAIR), or 30%–35% or even less (dollar-tied loans) (compared with 140% interest of Sberbank). The Jaroslavl subsidiary of Mortgage Joint-Stock Bank, using the minimum wage index, orginates loans with a 26% fixed interest rate. Thus, these instruments are enabling the borrower to increase the size of the loan he can take with a specified share of his income.[10] With these instruments the full interest payments are captured later in the life of the loan because the loan principal is indexed to the USD exchange-rate index or a cost-of-funds index. These instruments shift some of the increased interest payments required on the loan into the future when the borrower will be better able to pay them because his income will be higher.

Affordability of a mortgage depends to a great extent on its term. Russian banks making mortgage loans normally issue 10-year loans (Mosbusinessbank, Jarozslavl Subsidary of Mortgage Joint-Stock Bank, Mortgage Standardbank, etc.). Banks issuing loans through realtor entities in 1994 gave a one- to two-year term.

In 1995 Stolichny Saving Bank working with the "Universal Financial Company" offered 10-year dollar-denominated loans with an interest rate lower than for the shorter time loans. For example, a three-month loan carried a 27.5% annual interest rate; a two-year, 25%; a 10-year, 19.5%. Nevertheless, the result was quite unexpected: customers proved to prefer short-term loans (one- to two-year). This may be explained by instability of commercial enterprises and distrust of customers towards them.

Credit risk. The principal source of credit risk is the inability to provide the proper enforcement of the security of the loan, i.e., foreclosure of the loan and eviction of the borrower. Although foreclosure and eviction should be possible under the provisions of the Law on Collateral and the Code of Civil Procedure, the courts generally have not been receptive. Consequently, only a few banks actually originate mortgage loans based on the credit contract signed with a borrower and secured by a mortgage agreement (Mosbusinessbank, Jaroslavl Subsidary of the Mortgage Joint-Stock Bank and some others).

The most widely used scheme is so-called "selling of dwelling by installments" based on a lease agreement signed with a borrower with a provision for eventual purchase (lease-purchase agreement). This method is used in Moscow by Stolichny Saving Bank which began issuing loans in 1994. Some of its partners are as follows: Universal Financial Company; realtor companies, including "Housing Initiative," SAVVA, "BANSO" and others. This method is also used by another triple union comprising commercial bank "Neftyanoy," joint stock company "Neftyanoy–real estate company" and the realty company, "Krasniye Vorota."

The main provisions of this scheme are as follows:[11]

- The client applies to the realty company regarding purchase of a unit. The company can assist a client in finding the necessary dwelling, or the client can choose it himself. The realtor verifies legal title of the unit and guarantees it, as well as making a commitment to assist the client in obtaining a bank loan for the purchase. The company charges a fee for its services (5%–8% of the dwelling price, depending on the term and other provisions of the loan, and the firm's practice).

- The bank originates a loan to the borrower for purchase of an apartment on the terms of a dollar-denominated loan. Loan repayment is made monthly with payment of interest and partial repayment of the loan principal, excluding short-term loans (three to six months) when the loan principal is paid upon expiration of the loan period. The loan to value ratio is 67% for a two-year loan, 60% for three to five years, and 50% for six to 10 years.

  In case of a delay in payment for the period exceeding the agreed term, the bank is entitled to terminate the agreement on its own initiative. In this case, settlement with the borrower is rather strict. Only 50% of the downpayment is paid back (in some cases none is paid back), plus payments on the loan principal to date (considering the high rate of inflation, the value is much depreciated).

- The key participant in the scheme is the finance company, which purchases the selected unit for itself. For the bank this company acts as a borrower's guarantor, and in case the borrower fails to pay back the loan, the guarantor is responsible to pay the outstanding loan. At the same time this company concludes an agreement with a realty firm, stipulating the obligation of the realty firm to buy back the apartment at 25%–30% discount, if it is necessary due to the loan default.

The finance company concludes with the borrower a housing lease agreement with an option of eventual purchase; this is the basis on which the borrower occupies the apartment until the final repayment of the loan. Upon the final payment the borrower becomes the owner of the apartment. In practice, the lease agreement is concluded for a one-month term with an option to extend, if payment is made. If the borrower fails to pay in time, the lease agreement is terminated and the borrower evicted from the apartment, the finance company sells the apartment to the realty firm and pays off the loan. The finance company charges a fee for its services in the amount of 3.5% of the price of the apartment.

As for the borrowers using such procedure, they are normally independent businessmen and employees of the commercial companies. Underwriting of the client does not normally go further than the personal judgment of an interviewer. Moreover, the lender is not very interested in the paying capacity of the borrower, since in case of non-payment the bank will get its funds back from the guarantor who will sell the dwelling to the realty firm.

The transaction of taking a loan is very expensive for the borrower. Including the bank's service fees of 4% of the apartment price, and a 1.5% fee for property insurance (in case of loans for three or more years), such a deal costs a customer 14%–17% of the price of the purchased unit. These amounts are not returned in case of non-payment. Notwithstanding such strict lending terms, the operation of such structures is expanding due to the great demand for housing loans.

Funds mobilization. Banks have different approaches to the problem of mobilizing funds for originating housing loans. One option is opening targeted residential savings accounts. Mortgage Joint Stock Bank of Moscow was one of the first to provide its shareholders with a possibility of opening of such an account in March 1994. The minimum savings period is one year and the borrower must save not less than 30% of the price of the unit. Installment payments to the account are made in rubles, but the funds are indexed to the ruble-dollar exchange rate. Upon accumulating the necessary amount, the customer has the right to obtain a mortgage loan for a term of one to 10 years on a dollar denomination basis. The amount of the loan depends on the borrower's ability to make monthly payments.

The Moscow branch of Sberbank of the Russian Federation implemented such a procedure in February 1995.[12] At the start, savers can purchase cottages in the Moscow region, which are constructed by Miks company. The accounts are in a hard currency with a 5%

annual interest with annual compounding. With a minimum saving term of six months, the customer has to accumulate not less than 50% of the price of an apartment in a low-rise building or a single-family unit ($30,000–$250,000 per unit under the current prices). Units are supposed to be built within 6 to 12 months. The construction is financed by a credit line from Moscow Sberbank under the terms of 10% annual interest (dollar-denominated), which is very attractive, since the interest is considerably lower than that on the market.

After saving up the necessary amount of funds in the housing accumulation account, the customer will have an opportunity to move into a newly erected house, and the remaining amount is to be paid to the construction enterprise, "Miks." The terms of payment have not been determined yet; it is only known that the schedule of payments is calculated for 10 years, and until the loan is paid in full, the dwelling is the property of the "Miks" company.

Some banks are trying to solve the problem of obtaining resources for loans by selling loan obligations. For example, in mid-1993, Mortgage Standard Bank (MSB) began long-term lending operations with a single large enterprise, Kamaz, the truck manufacturer. MSB originates and services loans made to the enterprise's workers who are purchasing new units. Ten-year loans are made. The bank sells the loans at par back to Kamaz or a sister organization; Kamaz bears the credit risk. About 2,000 loans were originated in 1993, and a total of 12,000 are scheduled by the end of 1995. Thus, the bank obtains originating and servicing experience while avoiding most of the risks of mortgage lending. Kamaz in this case is able to produce additional housing for its workers at no greater cost that it did under the former arrangement of constructing rental housing. In this case, however, Kamaz has no responsibility for maintaining the units, as it would for rental housing.

The principle of working closely with an enterprise in providing owner-occupied housing to its workers is a sensible one, and one that banks in other countries have employed successfully. This version is not as robust as it might be, however. Our understanding is that MSB is not underwriting the loans, but rather simply lending to the workers presented by Kamaz. Hence, the bank is gaining no practice in underwriting. Moreover, the bank's incentive to service delinquent loans aggressively is clearly not very great under these arrangements. On balance, it is possible that the bank may be developing poor lending habits rather than valuable experience.

Today banks expect that the creation of the Federal Agency on Mortgage Lending will open a possibility of a permanent source for loan funds. The issue of participation of state and interested major commercial structures in creation of the Agency is under discussion in the government. The Agency is supposed to buy from banks residential mortgage loans which correspond to the Agency's standards of quality; and then it will issue its own securities, backed by these loans. The issue of providing the Agency's securities with guaranties of the government of the Russian Federation in order to make them more attractive for investors (pension funds, insurance companies, investment funds and individual investors through them) was also under discussion in the spring of 1995.

While banks increased the interest rates on loans sharply during 1993, there was no corresponding movement on rates paid on deposits. A few small banks offered higher rates, but Sberbank, which continued to account for nearly 90% of all household deposits, at the end of 1993 was paying an annual rate of 100% with compounding only taking place on an annual basis.[13] In this environment households energetically searched for higher paying options.

One response from the market was the creation of a kind of real estate investment trust. This scheme is operating in at least 10 large Russian cities (Moscow, Nizhniy Novgorod, Samara and others) and more schemes are being created monthly.

Sometimes private investment and construction companies use these procedures. For example, financial and construction company Povolzhskaya in the city of Samara was one of the first, or Ipotekobank in St. Petersburg. They attract public funds for housing construction by concluding special housing contracts, issuing bonds, bills and other securities. Very often the Oblast Administration is the main participant, acting as an issuer of so-called "housing loan" and housing bonds (Nizhegorodskaya Oblast, Ulianovskaya Oblast, the cities of Moscow and St. Petersburg).

The main items of the procedure are the following:

1. The issuer issues certain "housing certificates,"[14] which have, to some extent, two nominal values: one is in parts of square meters of total area of housing (for example, 0.1 sq.m. or 0.2 sq.m.) and another reflects the price of this part of a square meter (sometimes construction cost, in some cases the market price).
2. The "saver" buys housing certificates for a certain issuing price, which reflects the changes of construction cost (or market price) of one square meter of housing.
3. The "saver" who buys enough certificates to equal the number of square meters in the total space of an apartment, has the right to claim for an apartment as a redemption for his certificates.
4. The certificates may be put into circulation, and the issuer establishes certain rules for their repurchase at some indexed nominal value, with the terms of such repurchase varying from simple return of the initial nominal value of the certificate to a slightly discounted current selling price of the cer-

tificate, denominated against the current construction cost index or the market price for housing, or the Central Bank discount rate.

5. Conscientious issuers generally use the attracted funds for housing construction, sometimes for the purchase of housing in the market, and for placing part of the funds into bank deposits or state securities for the purpose of gaining profit or maintaining the liquidity of the certificates.

6. Two types of issues are distinguished: short-term (1.5 or 2 years) and long-term (10 years). In the first case the certificates are mainly connected with the construction of a specified housing unit[15] and in this case the volume of issue for the certificate is equal to the planned volume of housing construction. In case of long-term issues there are no such specific provisions.[16]

7. To sustain the investors' trust in the certificates and promote their liquidity, many private issuers attract large commercial banks as guarantors for the issues of the certificates; and with the same purpose the procedures are created, when the Oblast Administration acts as the issuer, and the securities are guaranteed by the funds of the Oblast budget.

In 1994, 27 bond issue prospectuses were registered in the Ministry of Finance of the Russian Federation in total amount of 500 bln. rubles (roughly $250 million depending on exchange rate assumptions). They were issued by different executive bodies of the subject of Federation.[17] The majority of them are residential (housing) loans.

Many reputable private companies attract administrations to act as guarantors in response to fraudulent activities of many firms, which attract public funds through different forms of securities, speculating on the lack of housing and offering enormous returns, backed by nothing. In the majority of cases such investments have led to disastrous results.

In June 1994 a Decree of the President[18] was issued in order to regulate the attraction of funds from the public in the form of securities for housing construction. The decree has the objectives of ensuring the targeted use of these funds, their safety, protection from inflation and a high degree of liquidity. However, since by May 1995 the Ministry of Finance and the Ministry of Construction of the Russian Federation had not elaborated the corresponding instruction, these various procedures for the issuance of certificates are still not mandatory. On the face of it, this scheme appears to be reasonably safe and likely to be profitable for the company and advantageous for the saver today compared with other savings instruments available in Russia. A key point is that the funds raised be actually invested quickly in real estate whose value will move with the construction cost index.

Note, however, that if a firm offering such contracts relies solely on the funds generated in this way to finance the construction of units and if it will only have the number of savers equal to the number of units in the building, then there is a good chance of the building's completion being greatly delayed. Obviously, other sources of funds are necessary, including commercial bank loans, bonds sales and others.

It seems likely that families will have a difficult time actually using the certificate mechanism to purchase a unit, certainly in the short term. That is why the possibility of exchanging one issue of certificates for those of the new issue is so important.

Taking a longer perspective, it is likely that this mechanism has limited possibilities because its success is connected with the period of negative interest rates for other types of financial instruments. When banks pay positive real rates, housing certificates will quietly disappear.

CONCLUSIONS

In May 1995 the prospects for long-term lending in the Russian Federation appear fairly positive, compared to the situation even two years before. Three factors argue for this view. First, there are clear signs that Russia may be achieving sustained relative economic stability, a factor which will obviously make longer-term lending more attractive to banks.[19] Second, the Russian banking sector has demonstrated remarkable creativity in determining options for making long-term housing loans at acceptable risk in Russia's difficult legal environment. The banking sector's performance in this sphere is consistent with its overall high rating among banking systems in Eastern European and former Soviet Union countries.[20] Third, the requisite training for such lending is rapidly being developed. The Association of Mortgage Banks and other groups are offering an array of training courses on a regular basis, and a series of tailored-for-Russia manuals for housing lending are now available, both through the sponsorship of USAID.

At the same time, the absence of a Law on Mortgage which would balance the rights of lenders and borrowers is a fundamental problem. Banks are now using lease-purchase agreements which afford them the necessary protection against default, but the terms are extremely adverse for the defaulting borrower. In fact, one worries that foreclosures on these terms will attract a legislation preventing such lending. As noted, passage of a balanced law will be difficult because of the provisions of the new Civil Code as well as the conservative nature of the State Duma. Passage of any law may well not occur in 1995 because of election year politics. Our realistic hope is for a good law in 1996, perhaps following an amendment to the Civil Code.[21] If this scenario is realized, long-term mortgage lending in Russia should develop rapidly.

NOTES

[1] National economy of the USSR in 1990, Annual Statistics—Moscow, "Finansy i statistika," 1991, p.187.

[2] Calculated using the data of the Goskomstat of Russia and the Ministry of Finance of the Russian Federation.

[3] Sberbank could afford that because its cost of funds that time was about 14%.

[4] Cables of the Sberbank of Russia and the Ministry of Finance of the Russian Federation as of January 14,1994 and July 28, 1994.

[5] The ratio is calculated according to the methodology of the "Housing indicators," recommended by the World Bank and Habitat, as ratio of price of typical unit to median urban family income. (The data given above pertains to Moscow.) A standard one-bedroom unit of 52 sq.m. total area, located in the middle sector of the city, is taken as a typical one. The ratio is calculated by T.D. Belkina.

[6] Presidential Decree, "On Development and Introduction of Non-Budget Forms of Investing into the Housing Sector," December 28, 1993, N2281; Presidential Decree, "On Housing Loans," June 10, 1994, No. 1180.

[7] Russian Federation Council of Ministers Resolution, "On Approval of the Regulations on Allocation of Allowances (Subsidies) Free of Charge for Construction or Purchase of Housing to Citizens in Need to Improve Housing Conditions," December 10, 1993, N1278.

[8] The survey was conducted by A. Tkachenko, consultant to the Urban Institute. During February-March, 1995, 19 companies, which are advertizing their activity in the mass media, were polled.

[9] Ravicz M. and R. Struyk (1993), "The Deferred Adjustable Instrument for Russia (DAIR) Product Description," Moscow: Urban Institute Technical assistance office.

[10] Meanwhile, it is necessary to emphasize that not all the banks or participating realtor firms engaged in crediting conduct loans underwriting. The reason for that is detailed later.

[11] Some features of the used scheme can vary upon the different groups of lenders. We will produce some examples illustrating activity of Stolichny Saving Bank based on results of a telephone survey of the joint stock company "Universal Financial Company" and on provisions of the article, "Instead of mortgage. Large banks are attracting customers with housing loans," written by E. Makovskaya, *Commersant Weekly*, No. 9, March 14, 1995. Some additional data are obtained by A. Suchkov (Urban Institute) interviewing a representative of the "Krasniye Vorota" firm.

[12] E. Makovskaya, "Instead of Mortgage," *Commersant weekly*, March 14, 1995, No. 9.

[13] In May 1994 Sberbank offered a new form of the deposit with monthly compounding rate at 12% (inflation was 6.9%). It was decreased later but was positive till September. Now, in March 1995, the interest rate on that kind of deposit is 7% (in Moscow, 8%) which corresponds to a 125% (150%) annual effective rate, while inflation is 178%.

[14] There are a lot of different forms of such securities or even agreements; that is why we will use the term "housing certificate," effective as mentioned above with the Decree of the President of the Russian Federation, "On Issuing and Circulation of Housing Certificates."

[15] For example, in January 1995 the Ulyanovsk oblast administration started the distribution of the second oblast housing loan to finance the construction of three 10-story residential buildings, consisting of 80, 120 and 200 apartments, in the city of Ulyanovsk.

[16] For example, the state housing loan for the Nizhny Novgorod oblast was issued for the term of 10 years. Its realization is assisted by a commercial structure—Nizhny Novgorod Property Foundation—which organizes the process of loan placement and utilization. At the initial stage it was decided to allocate the loan funds for the uncompleted housing construction (completed for 50%—90%) of the Joint Stock Company GAZ.

[17] M. Lanzman, "Municipal Authorities on the Stock Market," Newspaper *Segodnya*, December 27, 1994, N247 (354).

[18] The Decree of the President "On Issue and Circulation of the Housing Certificates," June 10, 1994, N 1182.

[19] In recent weeks there have been numerous positive articles in the popular press by experts. See, for example, A. Aslund, "Ruble Awakening: Why the Economic News from Russia Is—Surprise—Good!" *The Washington Post*, April 23, 1995, p. C-4.

[20] G. Pohl and S. Claessons, "Banks, Capital Markets, and Corporate Governance: Lessons from Russia for Eastern Europe," Washington, D.C., World Bank, Policy Research Working Paper No. 1326, 1994.

[21] The new Civil Code is being considered by the State Duma in two parts. The first part passed in late 1994. The second part was still under development in May 1995. It is possible that as part of the legislation consideration of Part II will be amendment to Part I.