

# **PRINCIPAL CHANGES IN LONG-TERM RESIDENTIAL MORTGAGE LENDING IN RUSSIA DURING 1998-2000**

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## **INTRODUCTION**

During this period, the system of long-term residential mortgage lending developed in a fairly difficult economic situation in which the 1998 financial crisis had a decisive role. The crisis caused material changes in the structure of the banking system and its areas of activity, suspended activities on the GKO market, and resulted in higher inflation and the decline in the real income of significant population groups. Several of the largest system-forming banks terminated activities, causing major losses to their clients. People who have lost their savings in the crisis have also lost their trust in commercial banks. The crisis also undermined the confidence of corporate investors, both foreign and domestic, in the long-term instruments which were to be issued on the basis of mortgage loans. Signs of positive change in the banking system appeared only at the beginning of 2000.

Nevertheless, along with conditions unfavorable for the development of long-term residential mortgage lending, some positive trends emerged during the period under review.

First of all, the use of mortgage for home purchase was getting increasing attention in various programs at both federal and subfederal level. In January 2000 the Government of Russia adopted a document called *Conceptual Basis for the Development of the System of Residential Mortgage Lending* which outlined areas of required improvements in the legislative and regulatory framework at the federal, subfederal, and local levels.

Secondly, despite the crisis of the banking system, and partly because of it, banks have turned to lending to the real economy, including the population. This has given rise to a new small but rapidly growing circle of banks which work steadily and professionally to develop their long-term home mortgages programs. Experience shows that once they gain access to long-term resources, banks are quick to launch retail lending operations.

Thirdly, administrations of the Federation subjects and municipalities assumed a special role in the creation of various mortgage lending programs. These programs declare the need to address social and economic problems through the mortgage system and, because of lack of credit resources and inertia among banks, they are mostly financed from local budgets which issue loans for construction or purchase of housing to the individuals on subsidized terms.

Lack of credit resources also inspired construction companies and developers to make active use of various schemes to attract private savings ranging from share participation construction to construction savings schemes to consumer and credit unions. (These schemes are described below.)

On the whole, despite the broad spectrum of approaches to the organization of lending in different mortgage programs, the following trends may be discerned:

- The legislation and regulatory basis for the activities of various participants of the mortgage market has improved at both federal and subfederal level.
- Different participants of the housing market, including banks, developers, brokers, and insurers are turning their attention to residential mortgages as a new and promising business.
- A greater number of banks are using traditional mortgage to secure loans issued to private individuals (with less reliance on lease-purchase agreements).
- Mechanisms for refinancing banks which originate long-term mortgage loans have been created and tested in practice.
- There is a growing understanding among the public and the state authorities of the role of the mortgage as a market instrument for addressing housing problems.

## **2. ANALYSIS OF THE SITUATION**

### ***2.1. State policy at the federal and regional level for long-term residential mortgage lending in 1998-2000***

The previously adopted Civil Code and the federal law *On Mortgage (Pledge of Real Estate)* created the legal basis for the origination of mortgage loans to the households for purchase of housing.

During this period, an important step in the formation of legal and methodological bases for mortgage operations was made with the enactment of RF Government resolution No. 28 (January 11, 2000) which approved the *Conceptual Basis for the Development of the System of Residential Mortgage Lending in the Russian Federation*. The resolution advises executive bodies of Federation subjects and local self-governments to use the document as a basis for regional mortgage programs.

The results of the first phase in the development of residential mortgage lending in the Russian Federation will strongly depend on the position of executive authorities at the regional and municipal level. Of special importance here are the activities related to the formation of an effective and efficient legislative and regulatory framework at this level.

The Conceptual Basis recommends that regional programs for the development of residential mortgage lending provide for adoption of the following legislation:

- Law of the Federation Subject on the development of long-term residential mortgage lending, providing for the creation of a reserve housing stock for households evicted from mortgaged premises by court order;
- Procedures for the trusteeship and guardianship bodies on issuing permission for the mortgage of housing units where minor children are living and for foreclosure on the premises in case of borrower default, and on building relations with commercial banks in the process of mortgage lending;
- Instructions on the registry of real estate rights in the Federation Subject on specific features of the registration of the mortgage of residential premises to ensure the speedy registration of sale and mortgage agreements for such premises.

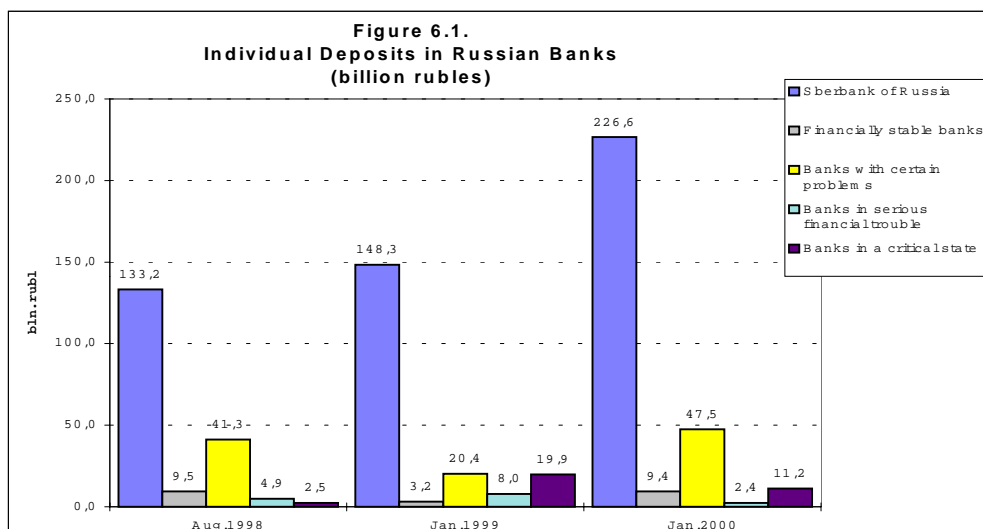
Several regions have already taken certain steps in this direction. For example, St. Petersburg has enacted the local laws, *On the Development of Residential Lending in St. Petersburg* and *On Houses for Temporary Residence*. The latter law provides for the formation of the housing stock for resettlement of evicted borrowers. The city bureau for registration of real estate rights has resolved all issues concerning registration of rights to mortgaged properties and the transfer of these rights in case of loan refinancing.

The regional administrations of Samara, Saratov, Novosibirsk and Khabarovsk have occupied an active position in the development of a regulatory framework for residential mortgage lending. At present, these regions are in the process of reviewing and approving their mortgage programs and implementing the supporting legislation.

## ***2.2. Economic conditions***

The August 1998 financial crisis had the greatest impact on the economic situation in Russia during the review period. As a result of the crisis, the market for state treasury bills was effectively frozen, the national currency suffered dramatic devaluation against hard currencies, and private savings kept in commercial banks lost their value or were lost to bankrupt banks.

Major changes also occurred in the structure and composition of banks which attract personal deposits. Fig. 6.1. shows the high deposit withdrawal rates experienced by several banks in August 1998, bringing them close to bankruptcy and forcing them to terminate operations (compare August 1998 and January 1999).



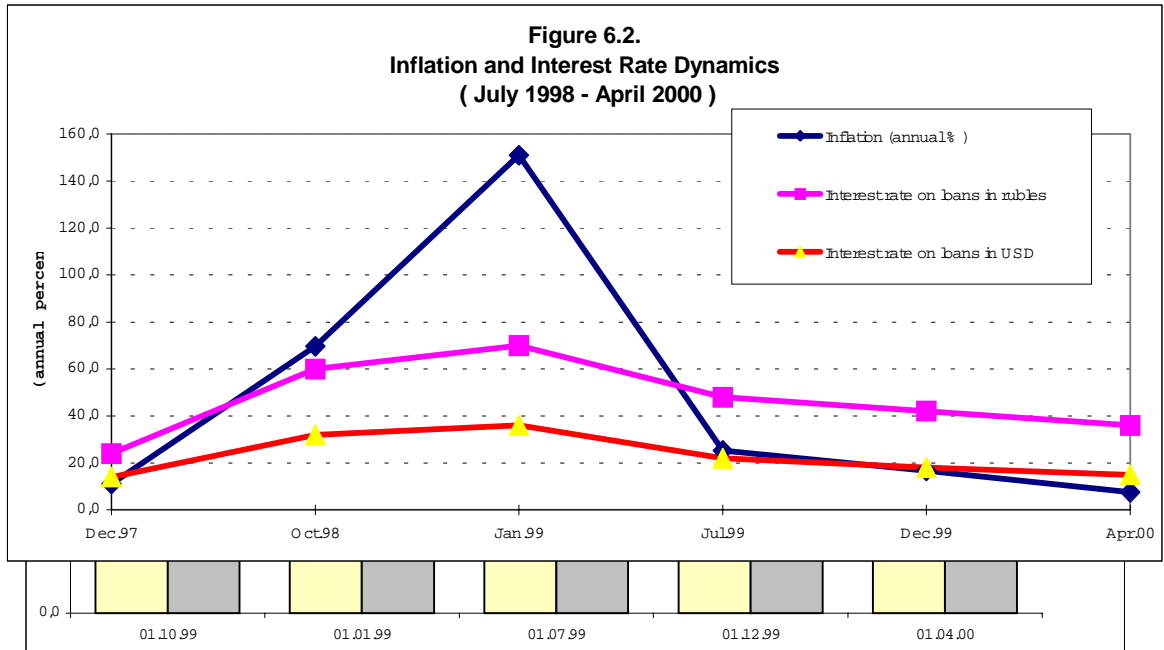
This primarily concerned large system-forming banks which prior to 1998 were the most serious competitors to Sberbank of Russia: SBS-AGRO, Inkombank, Menatep, Most-Bank, Rossijski Kredit. Personal deposits frozen in these banks were partly withdrawn by court orders and partly through Sberbank of Russia which returned the money through agreements with the bankrupt banks. Holders of currency deposits suffered major losses ranging from 40 to 50 percent of the account balances.

Public trust in commercial banks was seriously damaged. As a result Sberbank acquired a virtual monopoly on the retail market, and by 2000 managed to increase the volume of personal accounts in both absolute and relative terms. The inflow of personal savings was created mainly as a result of higher public confidence in the bank which is under government control and carries government guarantees.

The commercial banks which survived the financial crisis are seeking to strengthen their position in the real economy. In the absence of speculative currency and GKO markets, banks turn to the new area of retail lending, including home mortgages. Despite the troublesome state of the financial and stock markets, several banks have started lending for the purchase of housing. The move was driven both by the desire to occupy an advantageous position in a promising market and by mortgage lending initiatives in several large regions.

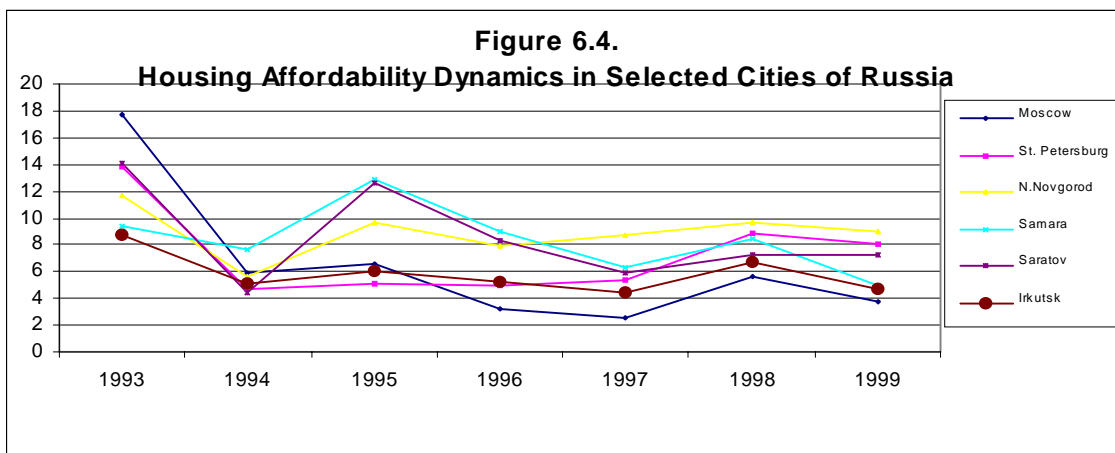
By the end of 1999 new commercial banks in Moscow and other regions entered the market for housing loans. This created a positive trend both from the viewpoint of depository base of these banks and the households' ability to accumulate downpayment funds for purchase of housing.

By the beginning of 2000 the decrease in inflation which started in 1992, and stabilization of the ruble after its dramatic devaluation in August 1998 created a new situation, which is more conducive to lending operations (Fig. 6.2.).



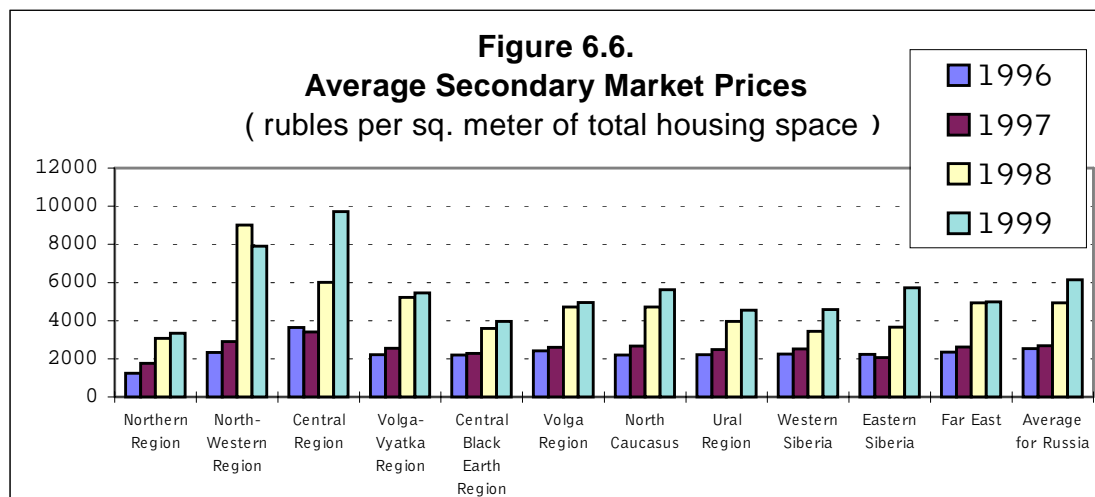
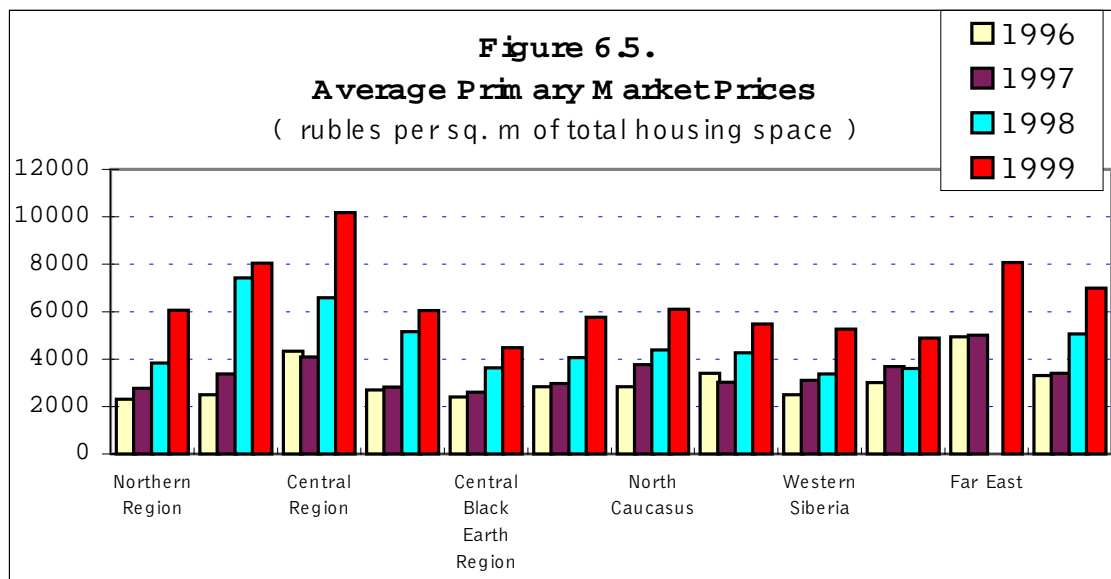
Compared to the pre-crisis period interest rates decreased on both ruble and currency denominated loans

The situation formed during 1995-1999 is reflected in the housing affordability index. Its dynamics in different cities is basically the same, though actual values may be different. The situation was most favorable in 1997, when growth in population incomes was accompanied by a slowdown in the growth of housing prices. In 1998 the ruble price for housing went up, but showed a slight decrease in hard currency terms. However, because no growth occurred in real ruble incomes of the population, actual affordability of housing decreased. (Data on the housing affordability index in selected large cities of Russia are shown in Fig. 6.4.)



In fact, the decline in effective demand for housing from the decrease in population incomes had a positive effect on the housing market. First, real market prices decreased for both secondary and primary units. Saturated demand for housing among the wealthiest population made sellers of housing on the primary and secondary markets decrease prices and focus on lower income population groups. However, prices for elite units designed for a narrow population group have remained the same.

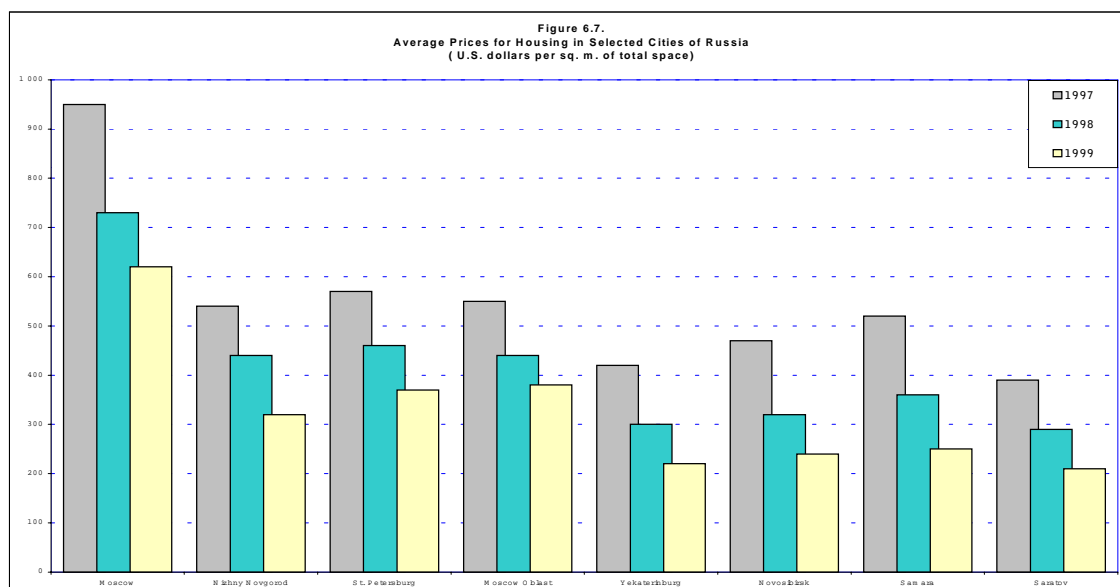
The average price of 1 square meter of housing space varies across the regions, as reported by the State Statistics Committee and shown in Fig. 6.5. and 6.6.



The impact of the financial crisis on the development of mortgage lending is best illustrated by the example of Moscow's construction industry which had no problems with the sale of constructed units till mid-98. The situation changed dramatically after the crisis as a result of reduced demand and satisfaction of the housing needs of the relatively small population

group that was able to buy a unit without a loan. To sell the units it had constructed, the Moscow Government was forced to consider various scenarios, including mortgage loans by commercial banks and various installment plans. It adopted a *Concept for the Development of Mortgage in Moscow*, which involved subsidized loans, and it made certain attempts to reduce the construction costs for standard units.

As noted, while average prices increased on both the primary (Fig. 6.5.) and secondary market (Fig. 6.6.) in ruble terms, prices in hard currency showed a substantial decrease (Fig.6.7.).



### 3. BANKS AND MORTGAGE LENDING

#### 3.1. Principal Trends

Changes which occurred in the field of residential mortgage lending during the review period may be summarized as follows:

- commercial banks which ceased operations were replaced by a larger number of new banks which entered the mortgage market;
- a greater number and share of long-term loans for purchase of housing are structured as a traditional mortgage in which the loan is secured by mortgage of purchased apartment or house;
- several regions have started to develop and implement regional residential mortgage lending programs;
- the regions are designing and adopting regulatory documents that promote the development of mortgage lending;
- work is underway to create the institutions and mechanisms for the secondary mortgage market;
- a greater number of bank personnel have participated in formal training courses to acquire knowledge of the basics of mortgage lending, loan origination and servicing procedures.

Prior to the August 1998 crisis, housing loans were issued by about 25 banks, including SBS-AGRO, Mosbusinessbank, Diamant, Menatep, Inkombank, Neftianoi, Vostoksibkombank (Irkutsk), Uralpromstroibank (Yekaterinburg), NBD bank (Nizhny Novgorod), Promstroibank (St. Petersburg). Most of these loans were based on lease-purchase agreements; limited use of mortgage was made. Several banks suspended their mortgage programs after the crisis. However, economic stabilization in the banking sector and the need to reorient activities from the GKO market to the real economy caused the banks resume mortgage operations.

In the past two years, more than 30 banks in Moscow, St. Petersburg, and several other cities have started operations in long-term residential mortgage lending. Noteworthy, banks turned to traditional scheme of lending for home purchases which involves mortgage of the purchased unit.

The loans offered by commercial banks which are most active on the mortgage market are described in Table 6.1.

**Table 6.1. Mortgage Loans to Individuals Offered by Selected Banks**  
(data for the beginning of 2000)

Bank	Loan Term	Interest (annual)	LTV	Loan Amount (min/max)	Notes
<b>Investsberbank (Moscow)</b>	Up to 10 years	27% (USD) - Own Program 16% - TUSRIF  10% - Moscow Government	70%	\$ 5,000-70,000 Apartment price may not exceed \$1,500 per sq.m.	Participates in three programs: Own Program TUSRIF Moscow Government
<b>Mezhprombank (Moscow)</b>	Up to 10 years	10-16% (USD)	70%	\$ 5,000-120,000	TUSRIF provides the funds
<b>Moscow Bank of Sberbank of Russia</b>	Up to 10 years	10-13% (USD)	70%	Max. \$60,000	Guarantees of 2 individuals with verified income
	Up to 15 years	37% (rubles)	50%	Determined on a case basis	
<b>Investment Banking Corporation</b>	Up to 5 years	15-18% (USD)	70%	Max. 150,000	TUSRIF provides the funds
<b>Sobinbank (Moscow)</b>	Up to 10 years	10% (USD)	70%	Determined on a case basis	Apartments in new residential developments
<b>Kazanski (Kazan)</b>	Up to 3 years	20-24% (USD)	50%	Max. \$ 30,000	Own funds
<b>Vneshtorgbank (Novosibirsk)</b>	Up to 2 years	10% (USD)	50%	Determined on a case basis	Own funds
<b>Uralsibotsbank (Yekaterinburg)</b>	Up to 1 year	25-28% (USD)	50%	Determined on a case basis	Employer guarantees
<b>Express-Volga (Saratov)</b>	Up to 5 years	40-42% (rubles)	50%	Determined on a case basis	Employer guarantees
<b>Tatfondbank (Kazan)</b>	Up to 7-10 years	15% (rubles)	50%		Resources provided through a specialized organization - Tatipoteka

These activities may be classified as follows:

1. Individual programs which the bank implements using its own resources.
2. The mortgage program of the Agency for Housing Mortgage Lending implemented through its St. Petersburg branch.
3. The mortgage program of the U.S.-Russia Investment Fund.
4. Program of the Moscow Mortgage Agency.
5. Regional mortgage programs.

In Moscow, 10 banks have started long-term mortgage lending operations within the framework of different programs. According to expert estimates, during the two-year review period they originated about 2,000 loans for purchase of housing. Sobinbank, Investment Banking Corporation, Mezhprombank and Rossijski Kapital have started mortgage operations; 1<sup>st</sup> OBK, Guta-bank, Probusinessbank and Rost are getting ready to issue their first mortgages, while Investsberbank and Sberbank of Moscow continue their mortgage programs.

The mortgage program of The U.S.-Russia Investment Fund (TUSRIF), with an estimated \$ 100 million in resources available for refinancing mortgage loans, includes the Investment Banking Corporation, Mezhprombank, Rossijski Kapital, Investsberbank, By March 1, 2000, about 100 loans were issued for the total of \$ 1.5 million. The loans are issued for 10 years in U. S. Dollars at a 15 annual interest rate. The maximum loan amount is \$ 150 thousand. TUSRIF plans to finance up to \$ 100 million mortgage loans in 2000.

The mortgage program of the Agency for Housing Mortgage Lending in St. Peterburg includes Inkasbank and Petrovski Bank; Baltijski and Promstroibank (St. Petersburg) are planning to join the program. So far only a few loans are involved.

Baltijski, jointly with the city administration and major developers, implements its own program of loans to private individuals for "share participation" for the construction of housing with elements of a mortgage. At present, the program covers 14 construction companies and 28 projects. Since the start of the program in August 1999, Baltijski has made about 40 loans for the total amount of \$ 1 million. 85 percent of the loans were taken to buy a new unit, and 15 percent to improve housing conditions using the equity of the old unit in loan calculations.

### ***3.2. Principal Changes in Bank Practices***

#### *Loan Terms*

In the period under review, loan periods have increased in Moscow and St. Petersburg. Previously, a typical loan was issued for 3-5 years. At present, loans are issued for 5-10 years, while some regional programs offer loans with a term of 20-25 years. Prepayment is permitted.

#### *Interest Rates*

Interest rates decreased from 35 percent to 15 percent for hard currency loans. Loans are issued and repaid mainly in a currency equivalent, with interest rate fixed in hard currency. In a number of regional programs, which issue soft loans at the expense of the budget, interest rates are established by administrative decision and reach about 8-12 percent in rubles. Note that the market interest rate for similar types of ruble loans originated by Sberbank of Russia equaled 40 percent in 1999 and decreased down to 25 percent by the fall of 2000.

### *Use of Mortgage*

Importantly, an increasing number of banks take a mortgage as the principal collateral for these loans. In contrast to the preceding period, when banks gave preference to “lease-based” housing loans, at present they are actively issuing loans secured by mortgage of purchased unit, and give great attention to the procedures for the origination and registration of such mortgages. Several banks have successfully implemented three-party agreements concluded between apartment seller, borrower and lender. A mixed contract permits to avoid many of the problems which arise if sale and mortgage contracts are concluded in consecutive order: registration of title for the purchased unit and of apartment mortgage may, according to the law, take 60 days each. Another group of potential problems relates to settlement and transfer of funds from the bank to the borrower and then to the seller. Every party involved carries the risk of non-performance by another party (for example, bank disburses the loan before mortgage of the purchased unit is registered, etc.). A three party contract makes it possible to register transfer of ownership and mortgage of a unit almost concurrently. This arrangement reduces bank risks, simplifies procedures, and reduces the time necessary to close the transaction. Three-party agreements are most broadly used in Moscow and St. Petersburg, and are gradually gaining recognition in other regions.

### ***3.3. Bank Risk Analysis***

Despite certain positive changes, long-term mortgage lending for home purchase and lending for housing construction, such lending failed to reach significant volumes for a number of reasons, including:

- incomplete legislation on mortgage lending operations;
- lack of access to long-term and inexpensive resources; high real interest rates;
- inadequate regulation of banking activities: several directives of the Central Bank fail to take into account some specific features of long-term mortgages;
- banks are discouraged from lending for construction and purchase of housing because of high perceived risk;
- low population incomes create low effective demand for housing among the greater portion of the population; lack of adequate savings for downpayments;
- lack of trust in the banking system among the public.

The most important risks for the banks engaged in long-term residential mortgage lending may be described as follows.

**Credit risk.** The law *On Mortgage (Pledge of Real Estate)* laid the foundation for use of a mortgage to secure long-term housing loans. However, the effective legislation is incomplete and sometimes ambiguous, which calls for changes in the Civil Code and the Housing Code. Cases of court foreclosure on mortgaged residential premises are rare. Most banks still see eviction of borrowers upon loan default as unrealistic because of conflicting provisions of the law and the general public attitude formed in the preceding period that termination of the right of residence is impossible even if the premises have been bought with borrowed funds. As a result the credit risk related to the impossibility of eviction and sale of collateral is regarded as high and causes banks to charge interest rates. When issuing home mortgage loans banks try to minimize their risks by means of a most cautious and conservative lending policy, prudent underwriting, title verification, and strict procedures for calculating maximum loan amount for each individual borrower on the basis of verified income data. While these measures do reduce credit risks, under the current conditions in Russia they have a negative impact on lending volumes because the number of qualifying borrowers is low.

**Interest rate risk.** Most of the Moscow and St. Petersburg banks use loan instruments with fixed interest rates in hard currency. This permits the banks to avoid major losses in case of unforeseen development in the economy and financial markets. However, it creates several other problems, mainly because most borrowers get their income in rubles, and income increases do not always correspond to changes in the dollar exchange rate. If a borrower's income is measured in rubles, there is the possibility of a "payment shock" in case of sharp variations in the exchange rate. The dominating position in the majority of regions is that currency loans (regardless of the interest rate) are unaffordable for the majority of potential borrowers, and thus the incidence of currency loans for purchase of housing is very low outside of the two principal cities. Most banks which operate in the regions originate housing loans either within the framework of regional budget-financed programs (soft loans in rubles) or use the same interest rate as Sberbank of Russia. The current rate used by the latter for ruble loans is rather high – 28-30 percent – reducing the ability of private individuals to take long-term loans for home purchase.

**Liquidity risk.** During the review period, several organizational financial schemes have been developed to reduce the liquidity problem. These schemes have enjoyed different degrees of success. But these approaches provided valuable methodological and organizational experience, creating a basis for further development of the refinancing system, including the secondary mortgage market.

Different models for refinancing home mortgages by specially created secondary market operators have been created by the mortgage programs implemented by the Federal Agency for Housing Mortgage Lending, Moscow Mortgage Agency established by the Moscow Government, and *Delta Capital* established by the U.S.-Russia Investment Fund. Similar organizations are being created in Bashkortostan (Ufa Mortgage Agency) and Irkutsk (Irkutsk Mortgage Agency).

Regional and municipal governments are creating various funds from both budget and off-budget sources to finance the banks which originate mortgage loans within the framework of their programs. Most of these programs are based on soft loans and have a limited scope because of the shortage of budget funds available for the purpose.

#### **4. REFINANCING MODELS**

##### ***4.1. Creation of Secondary Market Institutions***

Creation of the Agency for Housing Mortgage Lending as a secondary market facility was an important step in the formation of the organizational framework for the mortgage lending system. The Agency was established as an open joint stock company in which the state has the controlling interest (RF Government resolution *On the Agency for Housing Mortgage Lending*, No. 1010 as of August 26, 1996). At present, the authorized capital of the Agency equals 80 million rubles, and all shares are held by the state. The Agency has opened branch offices in St. Petersburg and Novosibirsk.

In the spring of 1999 the Agency launched a pilot project in St. Petersburg. Under this project, the Agency, buys mortgage loans originated by the banks for purchase or housing. The participant banks include Promstroibank (St. Petersburg), Pertovski, Baltijski, and Bank St. Petersburg. The Agency has concluded agreements with these banks on the refinancing of their mortgage loans.

The first loans were issued on March 1, 1999 for the total amount of \$ 80,180. The amount of individual loans ranged from 6 to 35 thousand dollars. Interest rates varied from 15 to 18 annual percent in hard currency. Loan term - 3-10 years.

The city has done substantial work to create favorable regulatory environment for the development of mortgage lending. It has passed local laws *On the Development of Residential Mortgage Lending in St. Petersburg* and *On Buildings for Temporary Residence*.

The Federal Agency for Housing Mortgage Lending has developed standards for the origination and servicing of mortgage loans which minimize the risks and ensure reliability of the emerging secondary market.

In the course of project implementation, the Agency tested its mortgage lending procedures and mechanisms for interaction with partner banks. However, lack of its own funds and inability to obtain the license of a credit organization have prevented further expansion of its operations. The Agency hopes to increase the volume of loan purchases in the future. For this purpose, the Agency has concluded an agreement with TUSRIF for a line of credit in the amount of \$ 5 million for refinancing mortgage loans. Under this agreement, the Agency selects partner banks and executes appropriate contracts which set forth the requirements for the origination and servicing of mortgage loans refinanced by the Agency.

In Moscow, the Moscow Mortgage Agency was registered in accordance with the Moscow Government resolution No. 194 as of March 16, 1999. The Agency was issued a license as a credit organization. Its main goal

is to organize the secondary mortgage market in Moscow and create a refinancing system for the mortgages.

As of March 2000, two commercial banks – Investsberbank and Moscow Bank of Sberbank of Russia – issued loans under the Moscow Mortgage Program. The loans were issued under the following terms:

loan currency – USD;  
loan term – 10 years;  
interest rate – 10 annual percent (fixed for the entire loan term);  
maximum LTV – 70 percent.

Borrowers are required to provide documented evidence of the availability of funds for the downpayment, and for income sources.

Within the framework of the Program, Investsberbank originated 27 mortgage loans for the total of \$ 580 thousand, the Moscow Bank of the Sberbank of Russia issued 100 loans. Lack of finance to purchase the loans from the banks originating the loans caused the program to suspend operations in fall 1999.

#### ***4.2. Direct Interaction Between Buyers and Developers***

To date, most construction companies still do not have access to bank credit for a number of reasons:

- the high price of bank credit caused by both the financial market and the complicated nature of construction finance;
- banks regard lending for construction projects as a most risky operation because of defects in the regulatory basis for the securing of such loans;
- banks' lack of sophistication in working with construction loans: origination and servicing procedures, risk management;
- lack of qualified bank personnel for the administration of construction loans.

The prohibitive price of bank credit has forced construction companies to seek other sources of funds. This gave rise to various schemes involving direct interactions between the buyers of units and developers. The most popular arrangements are:

- “share participation” in housing construction projects; and
- housing savings programs.

Given the unavailability of bank credit, these schemes have gained fairly broad acceptance.

In practice, financing of housing construction with personal savings is organized on the basis of an agreement of joint activities or share participation in construction and investment. The weak points of such schemes are shifting the construction and financing risks to private individuals, the opportunity to overstate the cost of construction works, and the violation of construction schedule and delayed commissioning of the

buildings. In addition, share participation agreements are not subject to registration. Practical experience has revealed the existence of a real threat that the number of agreements for a given building will exceed actual number of apartments in the building. Schemes are implemented using different forms of agreements. Private individuals are unable to control the complicated process of constructing a multi-family multi-story building, and thus their money is essentially advanced to the developer. In the event of incompetent or unprofessional actions of the latter, the money is lost.

In an attempt to increase the flow of investments from private individuals, developers have started creating savings funds, share partnerships, mutual aid funds, and credit unions without participation of banks. However, these arrangements carry the same risks as share participation construction in terms of construction delays and cost increases. The unions are usually created for a particular construction project, leaving the members little choice of a unit. Moreover, because the funds are raised by developers, who do not have a banking license, there is no external state control over the preservation and targeted use of the funds.

### ***4.3. Municipal Housing Bonds***

Housing bonds are a financing vehicle used by developers in Moscow, St. Petersburg, Saratov, Ulianovsk, and elsewhere. The bonds give households the opportunity to accumulate funds gradually. Each bond gives the right to the specified fraction of square meters of apartment area (e.g. 0.1 square meters). The bonds have a long maturity term – up to 10 years. A saver who buys enough bonds to equal the number of square meters in the total space of an apartment has the right to claim the apartment through redemption of his bonds. Typically, the available units are from housing constructed by the municipality. The bonds are priced and indexed in accordance with construction costs.

The limitations of such an approach to housing finance include:

- the bonds bring next to no income to their holders; their value is adjusted in accordance with changes in construction costs, rather than financial market; the bonds fail to perform the “accumulation” function;
- the bonds are of interest only to those who want to buy a unit, they have limited liquidity and do not support large-scale attraction of investments into the housing sector;
- bond buyers are given no choice when selecting a unit. The buildings allocated for redemption of the bonds sometimes fail to meet the quality requirements of bond holders.

## **5. REVIEW OF MORTGAGE LENDING IN SELECTED REGIONS**

### ***Main features of regional programs***

At present, several regions of Russia (Orenburg, Moscow, Udmurt Republic, Samara Oblast, Saratov Oblast, Nizhny Novgorod Oblast, Republic of Bashkortostan, Ryazan, and others) are trying to implement their own approaches to providing financial support for housing purchases. The most

widely used arrangement involves direct budget participation. This type of scheme is becoming increasingly popular among regional and city authorities. This is explained by a number of reasons:

- the wish to appear to be doing something to address local housing problems;
- attempts to boost the economy by stimulating inflow of funds from both private savings, budgets and off-budget sources;
- the need for some “transition” schemes for improving housing affordability until economic stabilization lowers interest rates.

Budget support for housing programs is provided in the various forms:

- interest rate subsidies to authorized banks (budget funds are used to compensate banks for the difference between the market cost of credit resources and preferential interest rates – the Udmurt Republic, Nizhny Novgorod, and others);
- loans at below-market rates from the budget (loans are issued using budget funds – *Rus* bank in Orenburg);
- provision of building materials and equipment by charging the cost to enterprises’ debts to the regional and local budgets and off-budget funds;
- issuance of municipal housing bonds and certificates.

Analysis of the currently used approaches to the problem makes it evident that, for all seeming differences, these approaches have one thing in common: an attempt to finance housing programs using the potential of local budgets. All programs are characterized by implementation on a small scale because of limited budget funds. The budget deficits of the overwhelming majority of cities make it impossible to replicate these schemes in other regions.

These programs can carry risks for participating governments and banks. A return of economic instability may produce substantial changes on the financial market. In pay-as-you-go schemes an increase in market interest rates will result in an increased budget burden. The funds allocated for the housing program may become insufficient for the entire loan term of 10 to 20 years (as is actually observed in practice) placing additional risks on the banks. However, it is difficult to estimate the funds which will be required for full financing of interest rate subsidies programs as interest rates strongly depend on the state of financial markets.

Recently, many subsidy programs of this kind (Udmurt Republic, Nizhny Novgorod) have been stopped as it became evident that the budget can no longer bear the burden after substantial increases in the market rates.

Most of the regional programs are intended to provide direct or indirect support to the construction industry, though budget expenditures for construction typically lead to such negative consequences as inflated construction costs and the freezing of funds in uncompleted projects. Broad use of offsets (building materials and equipment against tax arrears) to

provide commodity loans for housing construction also opens opportunities for overstating materials and equipment prices. Ultimately, this results in higher construction costs and complicated and non-transparent financing schemes. Because these schemes elude analysis, they are unable to attract market resources, investments, and commercial bank loans.

From the above it may be concluded that regional programs may have a limited role in addressing the housing needs of the population. But they are clearly laced with opportunities for inefficiency and corruption.

Basic parameters of the regional programs are summarized in Table 6.2.

**Table 6.2. Principal Housing Mortgage Programs Involving Bank Participation**

Program	Organization	Participant Cities	Loan Conditions	Program Volume	Notes
Federal Program	Agency for Housing Mortgage Lending (2 branch offices)	Moscow, St. Petersburg, Novosibirsk	10 years at 18 annual percent interest rate in USD	\$ 80,000	In Moscow and St. Petersburg – jointly with TUSRIF
TUSRIF Program	TUSRIF-Delta Capital	Moscow, St. Petersburg	5-10 years at 18 annual percent interest rate in USD	Loans were issued for \$ 1.5 million; Plans for 2000 - \$ 100 million	TUSRIF opens a line of credit to selected banks against rights of claim under the mortgage loans issued by these banks.
Moscow Government Program	Moscow Mortgage Agency	Moscow	10 years at 10 percent annual interest rate in USD	Initial plan – 5,000,000 USD	As of September 2000, no refinancing has been made.
	Orenburg Mortgage Corporation, <i>Rus</i> commercial bank	Orenburg	25 years at 10-12 percent interest rate in rubles	Loans were issued for 20 million rubles; the plan for 2000 is 20 million rubles	Loans for a constructed housing unit or for completing individual construction in rural areas. Maximum loan – 100,000 rubles. Paying capacity is linked to agricultural production volume.
Udmurt Government		Izhevsk		Over 3,000 loans	Sberbank issued loans

Program					with an interest rate subsidy from the republican budget
Bashkir Government Program	Construction and Mortgage Fund	Ufa	20 years at 7 percent interest rate in rubles	Over 1,000 loans	Subsidized interest rates
Tatarstan	<i>Tatipoteka</i> national mortgage center	Kazan	10 years at 12 percent interest rate	15 loans	Loans are secured by a mortgage
Nizhny Novgorod Oblast	Under Agreement between the Oblast and Sberbank	Nizhny Novgorod city and oblast	15 percent interest rate in rubles	5 million rubles allocated for the program	Sberbank loans with subsidized interest rates
Saratov Oblast	Targeted Programs Board: 3 credit unions, agent - <i>Nizhnevolzhsky</i> bank	Saratov and oblast cities	5-7 years at 7 annual percent interest rate	5 million rubles allocated from the city budget	Mortgage of housing; issue of zakladnayas for sale to investors
Sarov (Nizhny Novgorod Oblast)	Social Development Fund	Sarov	3-7 years at 7 percent annual interest rate in rubles under a sale-on-installment plan	Over 1,000 loans; maximum loan does not exceed \$ 2-3 thousand	The loan covers 15 percent of the unit price. The remainder comes from the unit equity and borrower's savings.

### *Moscow*

Moscow boasts the highest effective demand for housing and the biggest number of commercial banks interested in making mortgage loans. At present, several mortgage programs are being implemented by banks in the city. All programs were very small in 1999 and are likely significantly larger in 2000.

**Table 6.3. Mortgage Lending in Moscow in 1999**

Bank	Number of mortgage loans issued in 1999*	Total volume (\$ 000)	Notes
Investsberbank (Moscow)	27	390-410	Moscow Mortgage Program (loans in USD for 10 years at 10 annual percent)
Sobinbank (Moscow)	35-40	450-600	Moscow Mortgage Program (loans in USD for 10 years at 10 annual percent)
Sberbank (Moscow)	100	2,500	Guarantee of natural

bank)			persons is required (2-3 guarantors with the income comparable to the borrower's income)
Mezhprombank (Moscow)	10-15	250-300	TUSRIF Program (hard currency loans for up to 10 years at 15-16 annual percent)
IBK (Moscow)	35	400	TUSRIF Program (hard currency loans for up to 10 years at 15-16 annual percent)

\* Source: IUE estimates.

As reviewed above, the Moscow Government has created Moscow Mortgage Agency to finance the loans originated under the Moscow Mortgage Program. Apart from the activities targeted at creating the secondary mortgage market, other programs are implemented involving the creation of non-banking organizations for attracting funds from the population and originating mortgage loans:

- Construction Savings Program.
- Joint program of the Department of Extra-Budgetary Planning of the Moscow Government and Sobinbank.
- Joint program of the housing construction unit No. 1 (DSK-1) and the Moscow Bank of Sberbank of Russia (10-year loans secured by apartments purchased from DSK-1).
- Joint program of the *Mosstroimechanizatsyia-5* construction company and United Industrial Commercial Bank and the First Mortgage Company and some others.

The typical features of these programs are:

- the money for purchase of a unit is provided in the form of sales-on-installment plan; the units sold are from city-owned buildings or share participation construction projects;
- the choice of a unit is limited by the buildings and apartments offered for the program;
- downpayment – up to 50-70 percent of the unit price;
- relatively low interest rates – 8-10 annual percent in dollars – but fairly high price of the housing – \$ 600-1,500 per 1 square meter of total area (some interest costs shifted to the sales price);
- the loans now are made for 1 to 3 years, with plans to extend the terms up to 10 years in the future.

The Construction Savings Program (SSK) was launched by resolution of the Moscow Government No. 896 as of November 24, 1998 *On Organizing an Experimental Construction Savings Program in the Western Administrative District*. The program is designed to provide housing units in a newly constructed building under the following conditions:

- downpayment under an investment contract – 5 percent of the apartment price;

- savings – 45 percent of the apartment price, accumulated by equal monthly payments during 1 year (plans are to increase the savings period to 2-3 years) bearing interest in the amount of 1.5 annual percent on dollars;
- after commissioning of the residential building, a loan is granted for 3 –5 years at 8 percent annual interest rate in hard currency;
- the borrower acquires ownership of the apartment only after the loan is repaid;
- the borrower is required to take property insurance for the purchased unit and life and disability insurance for the entire loan term.

Financing schemes are often designed to combine the interests of banks and developers. Some banks issue loans at interest rates which are relatively low under the current conditions in Russia, e.g., 10 annual percent in hard currency. The loans, however, are not intended for “free market” housing purchase. The borrowers can buy units in specified buildings which developers or brokers sell at inflated prices. This arrangement enables the latter to keep the prices for new housing high and derive superprofits even when the units are sold on a 3-year installment plan or are paid for using a loan taken from a partner bank at low interest rates. These schemes were used in the following cases: (a) when developers are the bank’s founders and are interested in selling the constructed units founders for the highest price, and (b) the bank acts as an investor or creditor and is interested in getting its share of the constructed units sold for the highest price.

The joint program of the Department of Extra-Budgetary Planning of the Moscow Government and Sobinbank provides for a commodity loan in the form of an apartment from the buildings owned by the City and Sobinbank. The Department has allocated 100 thousand square meters, or 1.5-2 thousand apartments for the project. Despite the seemingly broad opportunities, the program participants cannot buy a unit worth less than \$ 550 per square meter, while the market offers cheaper units. Thus the program participants are forced to overpay, while the developers take advantage of their monopoly by deriving high profits at the expense of the buyers through inflated prices.

At present, the Moscow Department of Municipal Housing has proposed a new Concept for the development of residential mortgage lending.

The core of the document is a mortgage scheme in which loans are granted to households on the waiting lists for improved housing under preferential terms at the expense of the funds attracted as initial savings in the form of Municipal Housing Bonds.

The attracted funds will be invested directly into housing construction. Secondary market issues are not addressed. While creation of a secondary market operator – Moscow Mortgage Agency - is named among the anticipated results, its place in the proposed project is not identified.

***Samara Oblast***

Since late 1998 Samara Oblast has been working on the implementation of the mortgage program adopted by the Oblast Duma in the *Regulations on the Procedure for Mortgage Lending by Samara Oblast Housing and Mortgage Fund*. The Fund will originate mortgage loans for purchase, construction or renovation of housing. At present the Oblast has allocated 30 million rubles from the budget for the authorized capital of the Fund. Attraction of funds from the foreign sources is also planned.

The loans will have the following characteristics:

- maximum loan amount may not exceed 85 percent of the cost of the purchased or constructed housing;
- the loan is secured by the purchased (constructed) housing;
- the interest rate is determined by the Fund based on the market price of resources (at this time – RF Sberbank interest rates);
- loan term – up to 25 years.

The Fund is considering a bond issue to expand its financial base for the refinancing of mortgage loans. At this time work is underway to design a scheme for use of zakladnaya for the loans issued at the expense of budget funds. At present, it is planned to execute zakladnayas (a type of mortgage that is tradeable as a security under Russian law) originated by the bank for sale to Oblast mortgage agency.

In addition to this program, the Oblast is implementing a program of subsidized loans for selected borrower groups according to the lists compiled by the Administration. The loans are to be originated by *GazBank* (Samara) with the funds allocated from the Oblast budget. Borrowers receive title to the units. The loans carry an interest rate of 8-10 percent annually in rubles and are secured by mortgage of the purchased unit.

### ***Orenburg Oblast***

In 1997 Orenburg Oblast Administration adopted Regulations on the procedures and conditions for the origination of home purchase loans and created a joint stock company, Orenburg Mortgage Housing Corporation. It coordinates the activities of borrowers, banks, local authorities and other program participants. The controlling stake is held by the Orenburg Oblast Property Committee.

Loans under this program are provided by commercial mortgage bank *Rus*.

Borrowers' categories and interest rates are regulated by special resolutions of the Oblast Administration and are reviewed on an annual basis. The interest rate for each particular loan agreement is fixed for five years and may be changed by administrative decision only at the end of this term. Typical interest rates vary from 7 to 12 annual percent (in rubles). The loans are granted for the term of up to 20 years. Average loan amount is 100-150 thousand rubles. By summer 2000, 300 loans had been made. The 1999 budget allocated 23 million rubles for the mortgage program. The Oblast budget for 2000 provides for 35 million rubles; in addition, 20 million rubles will be attracted from off-budget sources. The total volume of

mortgage loans originated in 1999 equaled 11,642,200 rubles. Of these, loans for construction of housing equaled 7,547,000 rubles; loans for completion of an individual house – 895,000 rubles, loans for purchase of a unit on the secondary market – 3,200,200 rubles.

The loans may be secured by: mortgage of the housing purchased or mortgage of the land plot owned by the borrower.

### ***Sarov (Nizhny Novgorod Oblast)***

Sarov's program for housing construction and long-term lending is probably the most widely advertised housing finance program. For the purpose of the program, a special entity was created – the non-profit Social Development Fund (FSR), responsible for the financial support of the program. The starting capital was formed from two sources: (a) contributions from enterprises which are granted tax benefits, and (b) loans to the FSR from credit organizations. The money is used to construct new housing and to buy units on the secondary market. The third source of finance is the private savings of program participants. Non-monetary contributions to the project are also available, mainly in the form of uncompleted construction projects.

- Practical implementation of the program is assigned to the for-profit management company – Real Estate Agency. The Agency assembles the housing stock for sale to the program participants. For this purpose, it organizes construction of new housing, including use of uncompleted construction projects conveyed to the FSR.

Units previously occupied by program participants are submitted for resale by the FSR.

The value of the old unit which is charged against the price of the new unit is determined by the Agency. The amount of the loan received by the participant does not exceed 13-15 percent of the price of the new unit. The remainder is to be paid in hard cash.

The Sarov experience was used to develop the *Effect* system which is implemented in several other cities of Russia: Ryazan, Penza, Zarechny, and others. Overall, the program can be characterized as being complex with large transaction costs – ultimately paid by program participants.

### ***Ryazan***

The city's mortgage program was launched in May 1999. A specially authorized organization was established – the non-profit Ryazan Mortgage Fund - for organizing the program work on behalf of the city administration. The Municipal Commercial Bank, named after S. Zhivago, is one of the founders of the Fund.

Another program participant is the management company - Ryazan Regional Real Estate Center. The company is responsible for forming the

supply of housing for purchase on the primary and secondary markets by working with the developers and real estate brokers.

The budget allocates funds for investments in housing construction and the financing of home purchase. The funds are placed in the budget account of the Mortgage Fund. The program is intended primarily for retired military officers who have the right to a housing subsidy in the form of state housing certificates. The loans are issued to holders of the certificates to cover the gap between the price of the purchased unit and the amount of the housing subsidy. When a loan agreement is made, money is transferred directly to the sellers (developers) of the housing or transferred to a targeted blocked account of owners of state housing certificates.

The Fund, acting under the power of attorney given by the city administration, purchases housing with the budget funds and conveys it to the program participants on a deferred payment plan for 7-15 years. The loan is secured by mortgage of the housing unit. Title remains with the Fund until the loan is fully paid.

### ***Kazan***

Tartastan has created a national mortgage center *Tatipoteka* (hereinafter – the Center). At the initial stage, the Center concluded a cooperation agreement in the field of mortgage lending with a commercial bank *Tatfondbank*. The Center organizes construction of residential buildings in Kazan. Then it selects prospective buyers, evaluates their paying capacity, and conducts a preliminary qualification assessment for a mortgage loan. Constructed housing units are sold to eligible borrowers who have taken a loan from *Tatfondbank*. The loans are issued in rubles for 3 to 7 years in the amount of not more than 70 percent of the housing price at 12 percent annual interest rate. The bank has issued 15 loans which were refinanced by the Center.

### ***The Udmurt Republic***

The Udmurt Republic has two housing programs both of which entail active involvement of the republican budget.

The first program was launched in September 1994 and is implemented by the Governmental Fund for the Development of Mortgage Lending. The program targets two population groups: (1) public sector employees officially recognized as needing improved housing conditions, and (2) farmers and other residents in the rural areas. Housing loans are granted at the expense of the republican budget for the term of 20 years at 7 percent annual interest rate in rubles. The loans are secured by the pledge of liquid property or guarantees of one or more several individuals or a legal entity.

According to the data available, during 1994-1999 the total volume of loans granted at the expense of the budget reached 12,3 million rubles. Budget appropriations for the mortgage program in 2000 equal 12 million rubles.

The second program of subsidized loans for construction or purchase of housing was launched in 1997. The main participant is the Udmurt Bank

of the Sberbank of Russia. The loans are granted for 10 years at 7 percent annual interest rate for not more than 70 percent of construction costs or purchase price, but not exceeding the ceiling established by Sberbank of Russia. 3,194 loans have been originated under this program. Initially, the interest rate subsidy covered 17-20 percentage points. However, increases in the Sberbank loan interest rates soon made the burden on the budget unbearable. Budget shortage made continuation of the program in 1999 highly problematic.

### ***Nizhny Novgorod City and Oblast***

Nizhny Novgorod has a system of subsidized housing loans which was introduced in 1998. Local self-governments are responsible for compiling lists of eligible borrowers. Borrowers are then issued vouchers which give them the right to apply for a mortgage loan at Nizhny Novgorod Bank of the Sberbank of Russia.

The bank originates loans for construction or purchase of housing using its own funds. It has agreements with the Oblast and local self-governments under which the bank is compensated for the difference between the market interest rate used by the bank for similar loans and the interest rate established for the program participants. 40 percent of the subsidy funds are provided by the oblast budget, and 60 percent by the budgets of local self-governments. The interest rate is fixed at 8 percent for the entire loan term, which is 10 years. The loans are secured by mortgage of the acquired housing.

In 1999 City Administration of Nizhny Novgorod started another housing program. The concept is based on the Sarov housing program. The pilot project targets households with registered permanent residence in Nizhny Novgorod who have ownership of their housing unit, are able to provide at least 15 percent of the cost of new housing and have a stable and reliable income. The amount of downpayment and the value of the old housing should add up to at least 80 percent of the cost of new housing. The remainder is paid on an installment plan for up to 15 years at 7 percent annual interest rate.

### ***Republic of Bashkortostan***

The mortgage program in the republic is implemented in accordance with the resolution of the Cabinet of Ministers No. 15 as of 01/22/99 *Regulations on the Procedure for the Origination of Commodity Loans for Individual Housing Construction in the Republic of Bashkortostan*.

The lending process is organized by a specially created Presidential Housing Construction Fund. Its main function is to originate loans in the form of building materials using the materials received from enterprises in settlement of tax arrears to the republican budget. The loans are originated to "operators" which are represented mainly by interregional mobile teams of the agricultural construction company, Bashselstroi. The operator is issued a loan for 5 years at a 3 percent annual interest rate in rubles against the guarantee of the municipal and regional administrations.

The lists of eligible households are compiled by the local administrations. The loans are granted mainly to complete the construction of an individual house in the form of building materials for the term of up to 5 years (depending on the volume of remaining construction work) at 8 percent annual interest rate. Maximum loan amount is equivalent to 50 thousand rubles. The loan may be repaid both in money and in agricultural products. It is secured by pledge of real estate and other property of the borrower, employer's guarantee, or a guarantee of other legal entity or natural person.

### ***Saratov***

In order to create a mortgage lending system, the Saratov Oblast established a state unitary enterprise, "Targeted Programs Board", and assigned it with the development and conciliation of the regional mortgage program. In the summer of 2000 this program was approved by the Saratov Oblast Government, and is being reviewed in the Oblast Duma.

In June 2000 Saratov Oblast Government launched a pilot mortgage project. The oblast budget allocated 5 million rubles for the project. The mortgage program designed by the Targeted Programs Board entails the creation of mortgage consumer unions in the form of cooperatives. The unions are designed to attract the savings of their members to finance the loans for purchase of housing issued by the *Nizhnevolzhsky* bank under an appropriate agreement. The Charter of one of such unions - *Zhilstroj-ipoteka* - was approved on February 28 and at this time the union is working to attract prospective savers and borrowers. The program entails participation of enterprises as guarantors for loans taken by their employees. The Board intends to build its relations with the *Nizhnevolzhsky* bank on the basis of an agency contract. As of May 26, 2000 five mortgage loans, for the amount of 50-60 thousand rubles each, had been approved.

### ***Novosibirsk***

In 1999 the Federal Agency for Housing Mortgage Lending established a regional branch office in Novosibirsk to promote the formation of the secondary mortgage market and create a refinancing facility for the Novosibirsk banks which originate long-term mortgage loans.

At present, the work on the creation of the regional legislative framework for the mortgage lending activities is in progress. The Oblast law, *On the Development of Residential Mortgage Lending*, has passed the first reading.

The Governor has passed the decision to draft the regional program for the development of mortgage lending. The methodological and contractual aspects of the mortgage operations are studied by the *Levoberezhny* bank which is getting ready to sign an agreement on cooperation with the Agency for Housing Mortgage Lending. The bank plans to issue zakladnayas for the loans it originates and sell the zakladnayas to the oblast branch of the Mortgage Agency.

### ***Belgorod Oblast***

Several regions have followed the practices of Belgorod Oblast which created a fund for originating loans to individual developers repayable with agricultural products.

The paying capacity of a borrower, in the common understanding of the term, is not checked. Instead, the efficiency of the borrower's farm is taken into account, because the loan is repaid by agricultural products.

## CONCLUSIONS

By 1998 the great majority of banks had no practical experience and no methodological guides to organize mortgage loan origination and servicing. One-time loans for housing purchase were an exception rather than the rule and were not regarded as an activity which might generate adequate profit in the immediate future. The main reasons were seen as:

- defects in the legal base which failed to provide adequate protection for the lender and result in higher credit risks;
- inflation and economic instability, inadequate paying capacity of the population;
- lack of access to long-term finance for the banks.

Nevertheless, banks have show an increasing interest in residential mortgage lending. Their interest is partially explained by the search of lending opportunities – in this case in the real sector - as a result of the financial crisis. However, more important is the growing understanding among the public, residential developers, and regional and local administrations that long-term mortgage lending is a means of addressing the housing problem and the problems of housing sector finance. Critical is the general view that profitable lending can be undertaken in a risk-controlled environment.

The appearance of a broad variety of regional schemes of housing provision was driven by the need to address an acute social problem under the conditions which made active use of bank mortgage lending impossible. As a result, the regions have created various programs for financing developers and buyers of housing on the basis of schemes that make use of budget funds. These schemes are implemented by specially created “mortgage funds” that are controlled by the local administration and issue loans to the households, by-passing the banking system. The schemes are structured to permit favoritism in the selection of agent banks and borrowers.

For all the variety of approaches to housing finance across the regions, they have one thing in common: all require deep subsidies from regional or local budgets. The evident limitations of the regional programs lead regional authorities to understand the need to develop a market-based self-sufficient system of mortgage finance. At present, several regions (Saratov Oblast, Samara Oblast, Khabarovsk Krai, and others) are working on the creation of regional mortgage programs based on the market terms following the provisions in the *Conceptual Basis for the Development of Residential Mortgage Lending in the Russian Federation*.

From our analysis of the legal and economic conditions for the development of long-term residential mortgage lending we conclude that:

- the **basic legal framework** is being put into place. While the Law on Mortgage combined with supplemental local legislation today permits lending under acceptable risks, the RF Government and State Duma are considering badly needed amendments to the law On Mortgage (Pledge of Real Estate), the RF Civil Code, the RF Housing Codex, and several other legislative acts to create more reliable legal protection of mortgage lenders and investors;
- the **economic stabilization** creates prerequisites for a stable effective demand for long-term mortgage loans for purchase of housing;
- the **institutional framework** is being created at the federal and regional level by specialized secondary market operators could provide liquidity to the banks which originate mortgage loans;
- the **regulatory framework** is being created by the Central Bank within the framework of the *Conceptual Basis for the Development of Residential Mortgage Lending*. The bank is working on special regulations for mortgage lending and refinancing operations; and
- **investments**: the legislative and methodological basis is being created for the introduction of new financial instruments – mortgage-backed securities; lending standards and unified loan documentation have been developed to minimize the risks involved in long-term mortgage lending and to create conditions for attracting investments. Work is underway on a special law, *On Mortgage Securities*, to promote the flow of private investment funds to residential mortgage lending.