
**PRELIMINARY ANALYSIS:
MOSCOW COMMERCIAL REAL ESTATE LENDING MARKET**

Prepared for: USAID/Moscow

**DEVELOPMENT OF A REAL ESTATE MORTGAGE FINANCE MARKET
IN THE RUSSIAN FEDERATION**

*Contract No. EPE-0005-I-00-5070-00
Task Order No. 1*

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December 21, 1995

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I. Background

During the week of December 13 through 18, the Barents Group conducted meetings in Moscow with TverUniversal Bank, Most Bank, Bank Stolichny, MosBusinessBank and Rossiyskiy Kredit Bank. Each meeting was intended to:

- Provide the institution with details of the USAID-funded, Commercial Real Estate Finance Project (“the Project”)
- Gather information on the institution’s commercial real estate lending (CREL) activity
- Determine the obstacles to making a CREL, and
- Explore possible solutions with respect to these obstacles.

This paper summarizes the current lending activity in this area and states the substantive issues that are perceived as obstacles to an expanded or more active real estate lending market. Although a more time-consuming and comprehensive approach to this important subject is required before any meaningful conclusions can be drawn, preliminary findings are possible because of the source of the information as well as the consensus of opinion expressed by the lenders on key issues.

II. Current CREL Activity

A. Structure of Operations

Several banks apparently are making a commitment to the CREL market, by hiring specialists and creating CREL departments:

- At least three banks have formed special real estate departments exclusively designed for CREL activity.
- The other banks have appointed credit “experts” or specialists to work with the lenders on CREL transactions.
- Three of the banks have hired in-house lawyers and licensed appraisers who spend most of their time on this area of lending.

Hiring specialists and creating special real estate lending departments represent a significant investment. A return on the investment is expected in the form of future profits from CREL activity. This is a very positive sign for those interested in this market and an important step for the financial institutions. The reason is that normally

interest expense and labor are the two highest cost components on a bank's income statement. It is difficult to control the former, particularly in the face of loan demand and profitable investment activity and important to control the latter, by restricting new hiring unless one can make a case for clear revenue potential.

B. CREL Product Types

Based on our discussions, the CREL products currently available in the market are:

1. • Multi-family Loans. These are loans made to the owner of an apartment building or, on occasion, to the owner of a single family housing project. Although the ultimate end-user of the product is the homeowner, the project is initially considered a commercial loan.
2. • Owner-Occupied Transactions/Loans. These loans are typically made to a small merchant, shop, or bakery enterprise who buy their facility from the Government at an attractive price, normally around 33% of the market price, and sign a long-term lease for the land. Some bankers prefer these loans because the risks are relatively low for several reasons:
 - The low sales price means a strong loan to property value ratio (LTV)
 - The borrower is often an established company with an operating history or track record, and
 - The combination of these two points means that the debt-service burden is easily measured (and may be low).

Bankers looking for ways to further develop their customer relationships can do so with these transactions because there is an opportunity to make a second loan, using the same collateral, for financing renovations, equipment, or inventory.

- Non-Owner Occupied Transactions/Loans. These loans are the same as the Owner Occupied ones except that the buyer is a developer or investor, not the owner, and the purchase price is set closer to the true market price. The risk is greater for these transactions as there is generally a higher LTV and likely a higher debt-service cost.
- Syndications. Developers and investors may form an investment group to purchase a building from the Government. The developer will occupy a portion of the space for its operations.

- Loans Collateralized by Real Estate. An owner-operator will borrow funds to finance inventory or equipment and will pledge real estate as collateral for the loan.

C. Sample Terms and Conditions

While preferences regarding collateral, loan types and terms vary among lenders, some preliminary lending patterns are discernible and are detailed in the following table:

Sample Terms and Conditions

<i>Term Type</i>	<i>Terms</i>	<i>Comments</i>
<i>Amount</i>	\$100,000 to \$2 million.	Four of the five banks make loans exceeding \$1 million.
<i>Pricing</i>	24 to 50% per annum (based on hard currency).	Only one bank mentioned a rate over 30%.
<i>Maturity</i>	Generally 6 months or less.	One bank would make loans for one year, and one bank would for 18 months on larger loans. The short term lenders renew loans after 6 months.
<i>Fees</i>	Notary, legal, registration, etc. (No origination fees).	Most fees are charged to the borrower. Fees can approach 4 to 6.5% of the transaction.
<i>Collateral</i>	Transfer of the lease, property, and any other rights of the borrower allowed under the law.	Although <u>guarantees are not considered collateral in the U.S., they are considered an important source of support here.</u>
<i>LOAN TO PROPERTY VALUE RATIO</i> <i>LTV</i>	50 to 70%.	Varies according to transaction type.
<i>Appraisals</i>	Are generally required.	Prepared by a licensed realtor or an in-house expert.
<i>Repayment History</i>	Generally favorable for most of the borrowers.	There are no indications of any unusual problems.
<i>Geographical Limits/its</i>	In Moscow only.	Four of the five banks will only work in Moscow Moscow.

III. *Obstacles to CREL Transactions*

A. *Legal*

Without exception, every banker in every meeting stated that legal issues represent the most significant impediments to expanding real estate lending. In fact, with near unanimity, they responded that legal complications and uncertainties prevent them from being more active in the business. Other observations are:

- While the Moscow registration system is better than the registration system in most areas, it can take a long time to get clarification on prior liens and encumbrances. The data is not readily available. At best, this leads to a delay but it can also lead to legal errors.
- There are contradictions and gaps in the current laws. Misunderstandings related to the bank's rights upon foreclosure causes long delays and doubt with respect to the value of the collateral.
- It is not clear to the banks if a borrower can assign all of the rights with regard to certain property rights. In addition, there are legal limitations to some of the borrowers' rights. For example, does the privatized owner of a business with a 15 year lease have an automatic right to renewal at maturity or the right to sub-lease the property? If so, can the bank succeed to these rights? These areas need clarification or new legislation to address them, as they have a direct bearing on the value of the collateral.
- Although the real estate legislation is rather new, it needs updating. It refers to a Mortgage Law, but as yet there is no such law. Regulations are needed to clarify areas and, although Moscow laws are helpful, a National Law is necessary. Part One of the Civil Code is unclear on the bank's rights with regard to the collateral. A clear understanding is needed on individual land rights. Obviously, collateral is worth more and lending is less complicated where the fee simple ownership in land is owned totally by the owner.

Our preliminary findings on these matters are the following. Stating the obvious, *the banks must articulate their concerns in a clear and convincing manner at all legislative levels*. Perhaps a spokesperson for the banks already exists or a new one needs introduction. Either way, the banks will have a better chance of success if their position is represented by one persuasive voice that is known to speak on behalf of the banks as a community. Ironically, right now the banks apparently are searching more for

clarification of their rights, rather than for favorable legislation. This is not an unreasonable request.

While we must avoid the trap of thinking “If this was the U.S., the banks would...”, but this is one area where that approach might help. U.S. banks succeeded in getting laws passed and their rights clarified at the state level with regard to their security position for certain types of collateral through passage of the Uniform Commercial Code. Moreover, they recently succeeded in influencing changes in the federal bankruptcy law in connection with mortgage rights and foreclosure issues.

In the months ahead, we must search out the appropriate spokesperson for the lenders (Mortgage Bankers Association, Federation of Banks, or some other entity) and offer our assistance while, at the same time, exhausting other means of effectively communicating a consistent set of arguments. Legislative relief will allow the lenders to have a clearer understanding of their rights in mortgage collateral. Based on our meetings, financial institutions in the CREL market would then adopt a more aggressive lending posture without sacrificing loan quality. Clearly, this is in the best interests of the communities engaged in privatization.

B. Collateral

The three major concerns involving real estate collateral are:

- Legal/administrative uncertainties lead to a loss of confidence as to when, how, and at what price the lender is able to realize value from the collateral after default (see above discussion on legal matters).
- Valuation of the collateral is difficult for the banks to verify during the underwriting process, and
- The usefulness of potential collateral for CREL is a primary underwriting concern for the lenders. That is, the bankers generally agreed that the collateral has to be usable by the bank itself before the loan is considered. This is because the market for the collateral is illiquid and it helps minimize the cost and uncertainty surrounding foreclosure.

Our preliminary assessments regarding these matters are as follows:

On legal and administrative uncertainties: *as a practical matter, when an underwriter is faced with this situation, he/she will require other, more reliable forms of collateral and guarantees.* This other “support” is required in addition to, not in place of, the collateral being offered. While safer for the lender, this “over-collateralized” structure is not particularly helpful to the customer who has a finite amount of available

collateral, guarantees, and other forms of support. Each transaction becomes more expensive and ties up an unreasonable amount of collateral. Consequently, the customer is unable to undertake the amount of projects and higher levels of financing that are within its capacity, and probably available under more normal market conditions.

On valuation of collateral, *although licensed realtors provide valuations and analysis, at least some of the bankers are uncertain of the methods employed to reach the estimated value.* This seems to be more than a training issue, because other lenders complain that, even when comparable sales data is available, other factors interfere with an accurate value analysis. For example, a sales price from a similar sale of property may be understated because the seller wants to pay a lower profits tax and the buyer wants to pay a lower recordation fee. If this is a prevalent problem, the true sales price is probably unknown to more realtors unless one is close to the previous sales transaction.

Finally, on the usefulness of the collateral, the banks we meet commonly stated that they only accept collateral that the bank can use itself. Two banks tempered the statement by suggesting that some consideration is given to collateral that the bank knows can be leased to third parties at market rates. If the above position is prevalent among the financial institutions participating in a CREL, capital, not debt, will be the major financing vehicle for properties that can not serve as bank branches and offices.

In sum, *failing legislative or judicial relief for the collateral issues, alternative forms of real estate investment and lending are needed or many transactions will not go forward.* Clearly, more work is needed in this area or the CREL market will become quite limited.

C. Funding

The short term maturities for CREL reflected above under Section 3 are directly related to the lenders' inability to access medium to long-term funding sources. The banks are funding CREL activity in part from deposits which are available to fund the larger transactions for up to six months. Other sources include the interbank market, cash profits and bank notes, all short term vehicles. As stated above, most lenders will not lend over six months and only one lender would lend for more than one year.

Our preliminary assessment of this point is that *until economic conditions change and improve or some other funding source accepts the credit and currency risks present when lending on longer terms to the banks, CREL borrowers will continue to see short maturities for these loans.* More data analysis is required before conclusions are made as to the effect of short term maturities on the market, but the beginning questions include whether short repayment terms are:

- Placing an undue strain on the cash flow of an otherwise healthy borrower
- A major contributing factor to delinquency/foreclosure experience, and
- A major reason why a material number of privatization transactions fail the loan underwriting test?

In fairness, we should state that further analysis may indicate that the short repayment terms are not as onerous as they appear. For example, bank practices may permit renewal of the loans every six months where past repayment history warrants an extension period. Moreover, the amortization for these loans may be as long as 10 to 20 years, making the monthly principle payment considerably less than a loan that is fully amortized over a 6 month or 1 year period.

At present and in the absence of more data, the length of the repayment terms as described by the bankers is not conducive to a healthy real estate environment. Consider that the repayment terms for similar loans in other parts of the world range from 3 to 30 years. The reason for this is that long-term funding sources or a secondary market is available to the lenders to provide liquidity and an opportunity to increase yields and servicing fees, at times, without credit risk. When longer-term funding and lending are reflected in the terms of the loan, lenders and borrowers alike will reap the benefits.

D. Pricing

None of the banks are charging origination fees for a CREL, and most of the banks are charging in the 25% to 35% range for dollar transactions. All of the other expenses are passed on to the borrower, to pay for the closing costs or to reimburse the lenders for these costs. We are not able to determine the exact cost of funds to estimate a net interest margin at this time.

Our preliminary finding is that market comparisons are difficult for a number of reasons. This is a relatively new market with very short loan maturities; economic factors are present here that may not exist elsewhere; other bank consultants have indicated that there is a strong bank-borrower bond and loyalty here, perhaps similar to the U.S. situation before 1970. Some or all of these factors may not allow for different pricing.

A fundamental consideration is whether this business is profitable to the lenders. The answer is attainable after we determine the interest margin, loan loss experience, administrative/legal costs and other expenses related to this market. However, one question does surface for at least four of the lenders: are the financial institutions adequately compensated for the risks they are incurring for these transactions? For a one year construction loan, banks typically receive a 1% fee in the U.S. that is cash profit to the bank (accounting rules require amortization for longer-term loans). They also receive roughly 1% above prime or between 200 to 350 basis points above their cost of funds during the life of the loan. Discounting and present value adjustments along with average

loan life (longer or shorter) may somewhat change the profit estimate, but the approximate profit, net of interest expense and after fees, is 300 to 450 basis points. *Given the risks and uncertainties recited by the lenders for CREL transactions in Moscow, are the lenders receiving a fair price in return? We will explore this subject in more detail.*

E. Backlog

Most of the banks indicated that there is a healthy backlog of transactions “in the pipeline”. The past lending activity described by the banks together with a significant backlog indicates that, in spite of all the problems and uncertainties, the CREL market is finding ways to move forward. It may not be perfect, but it is alive.

IV. Summary and Key Conclusions

Despite the many problems with CREL, several banks in Moscow are forging ahead and doing CREL transactions. However, the problems they are facing are important. Our preliminary assessment of these problems is as follows:

- **Legal:** Legal problems constitute perhaps the greatest obstacle to CREL. Banks must articulate their concerns clearly and concisely. In the months ahead, we must search out the appropriate spokesperson for the lenders.
- **Collateral:** The legal, valuation, and need to use the collateral creates a strong need for legislative or judicial relief. Barring that, alternative or creative forms of real estate transactions are needed.
- **Funding:** CREL borrowers will continue to receive only short term loans, unless economic conditions improve and/or new and innovative funding sources accept the credit and currency risks present when lending longer term.
- **Pricing:** Given the risks and uncertainties recited by the CREL lenders in Moscow, the question arises as to whether banks are receiving a fair price and return.

We will explore each of these issues more deeply in the new year, and seek to find creative ways to either address directly or overcome the current impediments and problems in the CREL market.

The information received from the banks provided important background for understanding many of the relevant issues in a short period of time and will undoubtedly help us fulfill our task in the future. The challenges ahead are formidable. Complete

financial and economic factors, a changing political climate, substantive legal issues and collateral questions are disrupting the CREL market. Disruptions notwithstanding, the lenders and borrowers are using their imaginations and skills to go forward with a fair amount of CREL transactions.

Among other objectives, we fully expect to propose new financial ideas or concepts designed to compensate for an inadequate financing support system. We will assist lenders with the CREL activity to the point where one can track the progress as evidenced by increased CREL activity. We have established contact with several financial institutions and are rapidly gaining an understanding of the issues. The Preliminary Findings stated herein provide important issues for research and strategic review in the following weeks.