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

*FINAL REPORT*

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**Development of a Commercial Real Estate Mortgage Finance Market  
in the Russian Federation**

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## **Development of a Commercial Real Estate Finance Market in the Russian Federation**

### **I. Project Overview and Scope**

The USAID- funded project "Development of the Commercial Real Estate Mortgage Finance Market" (the Project) managed by Barents Group, LLC began in October 1995 and was completed on October 1, 1996. The program was initiated by USAID, GKI and RPC to address the expected increase in demand for financing of commercial real estate resulting from the implementation of the Russian Government's second phase of privatization of land, the relative economic stability and the emergence of positive real rates of interest, and the establishment of the legal basis for private land ownership. The principle task of the project was to enable potential [land owners and users to acquire their property rights and engage in commercial real estate development by providing them with access to resources of medium-term and long-term financing.]

The Mortgage Finance project was one of six projects initiated by USAID, GKI and RPC to address the issues of land reform. All the projects were targeted to address different obstacles in facilitating the rapid development of the market and were inter-linked to compliment and build upon each other to provide for a more efficient and effective means of accomplishing the goal. The five other projects included:

1. Enterprise Land Sales (ELS) -- designed to assist local governments in developing procedures to transfer land to the enterprises occupying the land.
2. The Housing Sector Reform Project -- designed to spur the privatization of housing by developing the internal infrastructure in Russian commercial banks to provide financing for individuals to purchase their apartments or houses.
3. The Real Estate Information System Project -- designed to spur the development of land and real estate markets by making available integrated and reliable real property information.
4. The Market Value Based Real Property Taxation System Project -- designed to assist local governments in valuing real property and administering fair real property taxes.
5. The Public Information for Land Reform and Privatization - designed to inform Russian citizens, government and civic leaders on issues and developments in land reform as well as to provide practical information on land reform, and to promote a deeper understanding among Russian citizens of land market issues.

These projects reflected the Russian Government's aim of modernizing land development and real estate finance in order to improve land use, to facilitate development of private land and commercial activity in the cities, to enable purchasers of commercial properties to finance acquisition of land, buildings and other structures, to improve local infrastructure and to stimulate private investment in various economic sectors of the country.

The ultimate mission of the Project was to promote privatization by preparing our pilot banks to finance CRE transactions by using real estate as collateral. The project focused on the two types of real estate lending (financing for new or existing commercial real estate development, and financing for business enterprises secured with their real estate). 1 2

The original objectives of the project were to 1) assist private commercial banks in selected cities in introducing the practice of secured financing through preparing and implementing credit analysis procedures that would allow lenders to design medium and long-term business loans secured by land and other property; 2) prepare banks to respond to market demands for real estate development financing in a commercial manner and protect their interests; 3) provide banks with modern methodology and adequate PC based computer applications to implement the newly prepared secured lending procedures; and 4) training bankers and real estate professionals in the procedures of evaluating, processing and issuing mortgage loans.

This project's scope evolved considerably throughout the diagnostic phase of the contract, as it became clear that certain tasks were not necessary due to the recent work accomplished by other land reform projects. Within the first weeks of the program the Team identified several "environmental" issues, such as high interest rates, competing investments, lack of long-term financing and the lack of a solid legal structure to regulate commercial real estate development, that the team could attempt to address, but could, at best, have a limited impact on given the scope and length of the project. To address the long-term financing issues, the Team added a task to research into commercial real estate financing. Thus, after the diagnostic phase, USAID and the Barents Team agreed on the following four objectives for the contract:

1. Institutional Infrastructure - Strengthen the pilot banks' capabilities to identify, evaluate, issue and monitor financing for commercial real estate transactions. This included providing advisory services for pilot banks' structuring new and restructuring existing commercial real estate transactions.
2. Legal - Review regulations and ordinances at the national and local level with regard to mortgages and registration. Suggest, where necessary, modifications or additions to these laws and ordinances that would assist in the development of the CRE market.
3. Intellectual Leadership - Conduct research to obtain a clearer understanding of the types of mechanisms that are currently used to finance CRE transactions, and where possible, identify new financing techniques for CRE transactions.
4. Non-Bank Entities - Where necessary, provide training to government officials and real estate related professionals, assist with improving registration mechanisms and disseminate public information on project activities and commercial real estate financing.

These tasks were designed to accelerate the process of land reform by supplying banks with the tools to provide financing for commercial real estate transactions that would be prudent and profitable for the banks.

The Team was successful in developing the procedural capabilities within our five pilot banks to carry-out commercial real estate transactions and in improving their ability to

properly identify, analyze, issue, monitor and when necessary, work-out commercial real estate transactions. However, the “environmental” inhibitors such as high interest rates on competing investments, legal obstacles, and lack of long-term financing, that were present at the onset of the contract, although softening a little, are still strong inhibitors to Russian banks rapidly increasing their involvement in the real estate finance market. The Team attempted to address these obstacles throughout the project, but because the short length of the contract and the inherent political and economic nature of these inhibitors, our impact was limited to advising on methods of pooling sources of financing and advising on changes to the national legislation. In-depth discussions of our work in these areas are included later in this report.

We do believe that the project was appropriately timed in the development of the Russian financial markets. The banks better understand the importance of adding commercial real estate to their lending portfolio and are eager to develop their involvement in this industry as the inhibitors discussed above become less and less of an issue, which is anticipated to happen in the near future. We have assisted several of the pilot banks to make their initial entrance into this market and to begin considering and analyzing CRE transactions and looking for innovative ways to bring financing for these transactions. The pilot banks have made a commitment to the market and are now prepared to continually move forward as the market becomes more attractive.

## II. Project Implementation

### A. Diagnostic Phase

The project's first four months were dedicated to identifying <sup>1</sup> pilot banks in pilot cities and redefining the work <sup>2</sup> to be accomplished by the Team over the course of the project. The Team relied on the advice and information from other contractors and parties interested in real estate finance in order to identify cities and banks that would make strong partners for the program. The Team met with the following organizations to obtain this information.

- USAID contractors, including the Urban Institute, Chemonics, and Arthur Andersen;
- Donor agencies, including the World Bank, and the EBRD; and
- Parties interested in real estate finance, including the Russian Privatization Center, the Association of Mortgage Banks, the Association of Russian Banks, the Russian Guild of Realtors, the St. Petersburg Leontief Research Center.

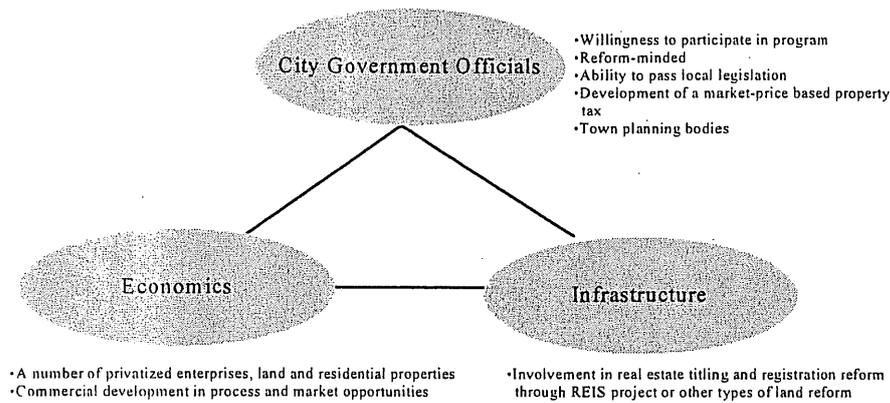
Based on information obtained in these initial meetings, the Team strategically selected cities and then banks to visit, to evaluate commercial real estate financing activities, ~~obstacles~~ to those activities, and the extent to which local banks were developing alternative methods to overcome these obstacles.

Prior <sup>1</sup> to visiting the banks, the Team developed a set of selection criteria for both cities and banks that served as the basis for evaluating the pro's and con's of working with the <sup>2</sup> different cities and banks.

1. City selection criteria

The city selection criteria was developed to identify where the project would make the most progress in developing the legal and institutional infrastructure to encourage bank lending for commercial real estate transactions. Of most importance were the city's willingness to work in the program, whether there was an existing REIS or registration system in place, and the local demand for commercial real estate transactions. City selection criteria was grouped into three general categories.

CITY CRITERIA TRIANGLE

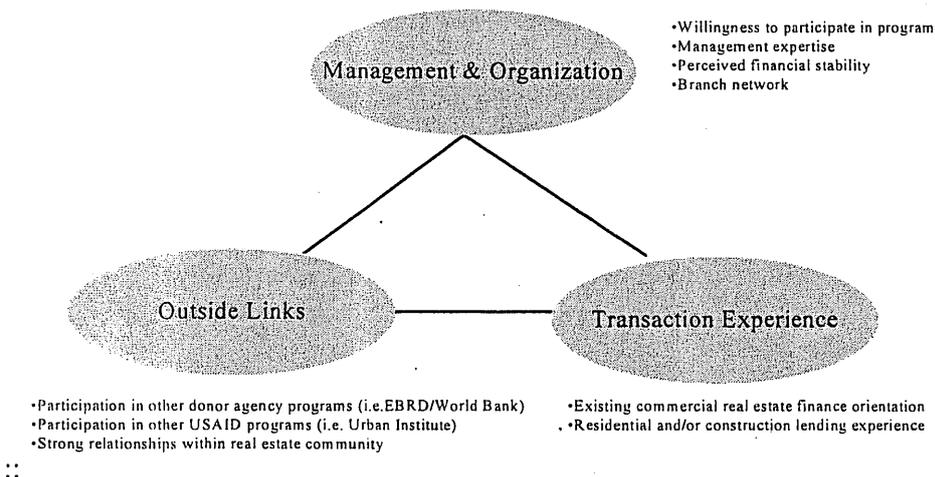


2. Bank selection criteria

The aim of the Team was to identify institutions that would quickly “add-value” to their current activities, either by improving on their existing transactions, or by introducing a new and attractive activity to a willing and enlightened management. By choosing these types of institutions, the pilot project was assured of proceeding as far as possible in the following months.

Bank selection criteria fell into three general categories:

BANK SELECTION TRIANGLE



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### 3. Final Selection Process

The team evaluated five cities and over 30 banks, and selected the four banks in three cities. The Team later added an additional Pilot bank as in order to expand audience for the information being transferred.

Moscow	St. Petersburg	Irkutsk
Stolichny Savings Bank	Bank St. Petersburg	Eastern Siberian
MosbusinessBank	Baltiyskiy Bank*	Commercial Bank

\*Added as a pilot bank after the program began.

Below is the analysis of how these cities and banks met selection criteria.

**Moscow** - The project did not initially intend to work in Moscow, due to the City Government's policies against the privatization of land, instead promoting long-term leases of 49 years. However, it became clear early on that in order to impact long term change, it was important to include Moscow banks in the program since they were the most active banks, their branches offered the best potential for the project's "roll out", and its banks were likely to be the first to carry out CRE transactions due to the fact that Moscow has the greatest economic and commercial real estate activity. It was understood that the city government would not be easy to work with and, consequently, the team focused mainly on banking issues in Moscow.

Stolichny Bank and MosbusinessBank, both strong Moscow banks, were chosen to participate in the program for two entirely different purposes. Other banks considered were Most Bank, Rossiyskiy Kredit Bank and TverUniversal Bank.

**Stolichny Bank** - Stolichny Bank was (and still is) considered one of the more active banks in the commercial real estate market and had real estate professionals with an impressive understanding and awareness of the issues. It was considered "solid" yet careful with regard to its commitment to this new and exciting market. Because of Stolichny's advanced understanding of the market, the Team planned to focus more of its efforts on assisting with transactions rather than starting at a basic level and building the bank's knowledge and skills in the real estate area.

**MosbusinessBank** - Mosbusiness is a long-standing and respected institution. It had a conservative lending strategy but an effective plan to aggressively attract professional assistance on real estate lending issues, and a strong desire to learn more about the market and explore alternative routes to helping its customers. These factors, along with the strong Moscow market and the ability to benefit from our assistance contributed to our choice of Mosbusiness as a pilot institution.

**St. Petersburg** - St. Petersburg met several of our criteria including having a reform-minded administration and a strong privatization program and being a participant in the REIS project. It was the second largest city in Russia and it had a potentially strong demand for financing teamed with a receptive and reform minded local government. In addition, St. Petersburg had sizable banks with branch networks and strong reputations that were very supportive of the commercial and industrial sectors, an important reasons

for focusing on the city. Lastly, land is freely conveyed in St. Petersburg which broadens the scope of CRET collateral. The Team, therefore, believed the city and its banks could profit from the new skills and information provided by our team.

*Baltiyskiy Bank.* Baltiyskiy Bank was added as a Pilot Bank in May as the program matured and the Team decided it was able to add another institution to increase the scope of the Pilot Project. Baltiyskiy met several of our bank selection criteria in the initial evaluation and was attractive due to its innovative and progressive attitudes and its interest in participating in donor agency programs. Even before Baltiyskiy was chosen as a Pilot Bank, it made a strong effort to keep up-to-date with the Project by sending its staff to the training programs.

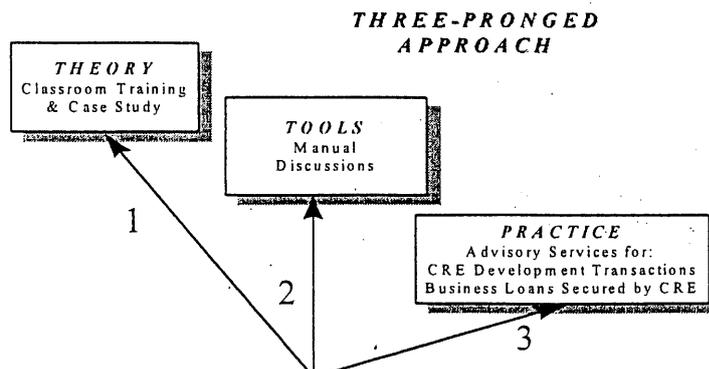
*Bank St. Petersburg.* Bank St. Petersburg appeared to be a well managed and respected institution and thus a logical candidate for the program. It was a participant in both the FIDP and the Housing Reform projects, proving that it has the dedication to work with western consultants and implement the programs developed. Senior management expressed its concern about doing transactions given the economic environment, but was very interested in finding ways to resolve transactional issues and obtain greater capabilities for conducting CRE transactions.

*Irkutsk* - Irkutsk was strongly recommended by several parties (including Housing Reform, ELS, The US-Russia Investment Fund) as an economically dynamic city with a reform minded government and a very attractive bank. The combination of those factors placed Irkutsk high on the list of cities with which to work.

*Eastern Siberia Commercial Bank* - This bank was a former commercial and industrial bank with a long history of working with the commercial sector and was known for its progressiveness. The bank financed CRE transactions involving the largest privatization projects in the region. The bank was working closely with local developers on the construction of new housing and planned to expand its activity with local enterprises.

### B. Institutional Infrastructure

One of the main objectives of the project was to develop the institutional infrastructure within the Pilot Banks and equip them with the tools to identify, analyze, issue, and monitor commercial real estate (CRE) transactions. The Team implemented a three-pronged approach to accomplish this goal.



1. Provided formal class-room training on theoretical concepts of commercial real estate lending and appraisal.
2. Developed a Commercial Real Estate Lending Policies and Procedures Manual that outlines prudent lending policies and procedures that should be adopted by a bank interested in entering this line of business.
3. Provided hands-on assistance to the pilot banks to identify, analyze and carry out prudent and profitable CRE transactions.

The three-pronged approach was meant to complement the bankers' existing skill set and reference materials. The Banks were chosen because of their familiarity with CRE mortgage transactions from either their work under residential mortgage transactions, CRE investments, or business loans for their customers. However, they needed to upgrade their tools to incorporate CRE mortgage principles. Their existing tools included manuals and training provided by the Urban Institute under the Housing Reform Project.

#### *1. Classroom Training*

Three class room courses, aimed at transferring the basic knowledge and skills for CRE lending, were developed by the Team and taught by U.S. real estate practitioners with experience in Russia and Eastern Europe.

Commercial Real Estate I - The Commercial Real Estate (CRE) Lending course discussed the different types of CRE projects including: Commercial office/business centers, retail/shopping centers, lodging/hotels and industrial/warehouse; commercial business loans secured by real estate; and owner occupied real estate. Organizational topics were described and analyzed including: how to organize a CRE loan department, how to develop the necessary policies and procedures, recommended structures for a CRE division and how to market CRE transactions. The course also addressed the basic principles of credit analysis, tenant analysis, underwriting, documentation, problem loans, appraisal techniques, construction issues, loan structure and loan monitoring.

Commercial Real Estate Workshop - The CRE Workshop focused on deepening the level of understanding provided from the basic principles learned in the CRE I course. This was accomplished by transforming the principles into practice with Russian case studies. The case studies allowed the managers to practice the tasks required to analyze and appraise a project, using techniques of project analysis, income/expense projections, the income approach to appraising real estate values, cost over-runs and other project problem issues.

Commercial Real Estate Appraisal - The Appraisal Policies and Procedures Course addressed real estate appraisal techniques, focusing on the income approach, and the procedures for ordering, reviewing and adjusting appraisals. A sample Appraisal and an Appraisal Procedures Manual were introduced and discussed for implementation in a Bank's Appraisal Department. Topics addressed included income/expense analysis, determination of net operating income, derivation of capitalization rates, income

capitalization, investment and loan indicators, underwriting criteria for loans, time value of money, discounted cash flow analysis, and after-tax investment analysis.

Participants in the courses were from Russian financial institutions, both Pilot and non-Pilot Banks. The strong participation of non-Pilot Banks and their regional scope of the participants indicated there was a strong demand for training in the principles of commercial real estate financing. Non-Pilot Bank participants included individuals from Inkombank, Rossiyskiy Kredit, Novobank, Promstroï Bank in St. Petersburg, TverUniversal, and several others. In all, over 75 real estate professionals were trained from banks, associations, other AID projects, and government officials.

The course schedule for our seminars occurred as follows (See attached course agendas and materials in the appendix):

Date	Course	Attendees
April 1 - 3	Commercial Real Estate Lending I	13 people
May 13 - 15	Commercial Real Estate Lending I	9 people
May 20 - 24	Commercial Real Estate Workshop	17 people
May 27 - 28	Commercial Real Estate Workshop for Stolichny Bank	10 people
July 4 - 8	Commercial Real Estate Appraisal	20 people
July 22 - 23	Commercial Real Estate Workshop for Baltiyskiy Bank	4 people

The Team provided each participant with a copy of the training materials, and Pilot Banks with several copies. It was hoped that the participants would return to their bank and use the workbook to train others in their divisions in the principles and concepts covered in the course. The workbooks could also serve as a foundation on which to build a commercial real estate training program for new employees who will join the real estate division. As the market becomes more friendly towards real estate financing, banks will need to expand their divisions, thus requiring training for these individuals. Establishing a system now will prepare the bank for future needs. (See the appendix for copies of the courses)

## *2. Policies and Procedures Manual*

Over the course of the Project, the team developed the Commercial Real Estate Lending Policies and Procedures Manual (Manual), as a standard manual to be used by Russian banks interested in entering the CRE lending market. The Manual outlined prudent lending policies and procedures and provided banks with standard documentation written according to Russian and Western laws to protect a banks' interest in case of a dispute or foreclosure.

The necessity for a Policies and Procedures Manual was identified in the needs assessment as an essential tool in developing a framework for the real estate division. Until now, the departments were small and there were enough day to day contact and discussions to ensure that all personnel understood the requirements and limitations for lending. However, the divisions were beginning to grow and management found it was in need of a standard format that defined what the bank expected from its employees. It is

expected that the financial institutions will continue to modify the Manual to further define the regulations to take into account the banks' industry focus and other issues.

Another essential component to the manual is the legal documentation (See next section for details on this work). Some pilot banks moved forward in developing the necessary documentation for commercial real estate transactions, and, in some cases, the documents proved they could stand-up in court when challenged with a dispute or foreclosure. However, the banks believed that the documentation provided, at the very least, the assurance that they covered all of the necessary clauses and thus, they have strong documentation. For those that did not engage in the document development exercise, the documents provided a strong foundation to use in building their division.

The Team conducted monthly visits with the Pilot Banks to lead detailed discussions of the manual chapters, describing methods of implementing the policies and procedures within each bank. These meetings provided a forum for the staff to ask questions about the manual sections and to discuss issues they encountered during project analysis, monitoring or work-outs. They were able to request the team's advice on how to handle specific loan situations, and how the manual reflected policies that would protect a bank under specific situations.

### *3. Transactions*

The Team provided consultation to all Pilot Banks in identifying, analyzing, completing and monitoring their CRE transactions and assisted with over 10 loans, of which 2 were issued. The Team set the groundwork for this through classroom training and by providing the institutions with the necessary policies and procedures. Once that was accomplished, the advisors on the Team worked closely with loan officers to put this theory into practice by analyzing loans that were submitted to the bank for its consideration. The extensive experience of the Team's advisors provided the means to advise the loan officers on different approaches for analyzing a loan and how to complete, monitor and work-out CRE loans.

The consultation included advising the Loan Officer on types of questions to ask the potential borrower, how to apply different valuation techniques in appraising real estate as collateral, how to review a proposal's market analysis, how to ensure the proposed development was the highest and best use of a property, how to analyze the market supply and demand and the impact of the new development on the market, and how to evaluate the viability of a transaction.

The Team's varied success in implementing this part of the program was anticipated, as one of the initial concerns of USAID and the Barents Team was whether the economic situation in Russia would sustain a bank's immediate involvement in CRE lending. Overall, the Team was pleased with the pilot banks' activity in the real estate market, their openness in sharing transaction information, and their willingness to listen to advice on analyzing loans. However, due to confidentiality agreements with clients and general mistrust of non-bank officials, the often times the Banks were reluctant to allow the Team to assist with all parts of a transaction, but instead requested our advice on specific pieces of transactions such as collateral valuations,

market studies, or financing structures. However, several Banks indicated that were the project to continue, they would be interested in drawing on the resources of the Team on an increasing level to assist with transactions.

For reasons discussed in section two of this paper, the Pilot Banks chose to issue business loans secured by real estate or privatization projects, rather than straight financing of commercial real estate deals. This appears to be a prudent decision as the risks and amount of financing involved were substantially less than in real estate development. (see appendix for further information regarding our work with each pilot bank and the transactions reviewed).

### *C. Legal Issues*

The basic tasks for the legal component of the project were to:

- Evaluate and suggest recommendations on national legislation issues;
- Review and analyze legislation and regulations at the oblast and municipal level and to identify gaps, if there are any, with regard to registration and foreclosure;
- Draft legal documents for CRE financing for the Manual; and
- Advise the Pilot Banks on the legal aspects of conducting CRE transactions, where necessary.

#### *1. National Law*

There are provisions loosely relating to mortgage law in Russia within the Civil Code. However, the Civil Code contains broad, provisions dealing with secured lending generally, but was never intended to provide final guidance for real estate mortgage lending. In fact, the Civil Code specifically states that real estate mortgage lending be governed by a Law of Real Estate Mortgage, not yet passed. Consequently, most of the legal focus of the past several years in this sphere has been on developing and negotiating the Law of Real Estate Mortgage, which, together with the Law on Registration of Real Estate Rights and Transactions, will form the basic law governing the sector.

The mortgage law, if enacted today in its present draft form, could create a minimally adequate basis for commercial mortgage lending. However, even though there is no single flaw of insurmountable proportion, the law is characterized by numerous ambiguities and potential contradictions, and may therefore fail to achieve the objective of increasing confidence in mortgage lending. At the least, in its present form, the law might delay growth of mortgage lending as the judicial systems labors to resolve its many ambiguities. Problems with the law range from minor, such as a short period of time to make payment on auction bids at public foreclosure sales, to significant, such as failing to clarify the impact of intervening liens (e.g. contractor mechanics' liens, etc.) on construction mortgages registered by real estate lenders. The Team's legal advisor's report addresses the cumulative effect of the flaws and ambiguities in the law; 40 specific recommendations are made to modify the draft in a way that would resolve questions and create confidence from the start. (See appendix for complete analysis of specific recommendations.)

The Team initially reviewed the Legal Issues with regard to CRE in December 1995 (See attached report). This report was updated in July to address the legal issues that would

remain if the proposed mortgage law was enacted. The report assumed that the Law on Mortgages would be adopted, as is, and then discussed inadequacies that would remain after passage. The recommendations made by our legal advisor were reviewed by a Russian legal expert to ensure that the information and recommendations contained in the paper accurately reflect Russian Law and the Russian legal system.

The Legal Advisor met with members from the mortgage law working group and Mr. George Zadonski, an original sponsor of the proposed Mortgage Law in the State Duma, to review the proposal for changes to the proposed law that would enhance commercial mortgage lending. The mortgage law working group noted the Legal Advisors' comments and assured the Advisor that efforts would be made to introduce the most important changes in the ongoing mark-ups of the law.

## 2. *Regional/Oblast*

Analysis has concluded that the laws of mortgage and registration are federal laws that can be affected only tangentially by local law. The fundamental law on mortgages at this time, pending enactment of the long-awaited Mortgage Law, is the Civil Code of the Russian Federation, which may not be altered or modified by local laws. Similarly, the Civil Code specifically provides that the national system of registration will be created pursuant to a federal law, which at the close of the project was in a "conference committee" of the State Duma and the Federal Council to resolve differences between the two houses of the legislature.

Despite the federal nature of the crucial laws of mortgage and registration, it is also clear that local efforts to improve policies, regulations and administrative systems can be important for creating an environment which encourages mortgage lending. Three issues of a primarily local nature are outlined in the report of the US legal advisor:

- *Improvement of privatization procedures.* Some participating banks complained that the procedures and documentation for privatization of real estate were unreliable, causing serious concerns about the quality of title and forcing banks to virtually duplicate the entire privatization process in their underwriting. While laws of privatization are essentially national, the amount of effort localities take to implement privatization laws through reliable procedures and documentation can make a large difference in the quality of real estate titles.
- *Land Privatization and Leasehold Mortgages.* Private ownership of land for commercial real estate projects is permitted under national law, as is mortgage of lease rights. However, local policies frequently discourage both. Localities can enhance mortgage lending by improving local policies on land privatization and mortgaging of city leaseholds.
- *Registration.* Although registration law will be national, at this time, in the absence of a national law, many localities (St. Petersburg among them) have taken the initiative on the basis of the existing laws to create good local regulatory and administrative systems for registering mortgages, while others have not. This is another area in which local initiative in regulations and administrative procedures would have

benefits for mortgage lending pending creation of the unified national registration system called for in the Civil Code, which might take years to implement.

### *3. Legal Documentation*

Perhaps because commercial real estate mortgage lending is not yet widespread, few banks have developed sophisticated legal documentation. Moreover, in the absence of the mortgage law the full scope of legal rights and remedies available to the lender is not yet understood. Even the rights and remedies provided in the Civil Code, which has been in existence since the end of 1994, are not yet fully understood as there has been little call to interpret its provisions on secured lending.

Accordingly, the approach taken to the legal documents was to provide for consideration by the participating banks as many alternative legal structures and security devices as possible, consistent with the basic tenets of Russian law. Along those lines, the documents anticipate various types of commercial real estate transactions, ranging from the loan for income producing investment property to a business loan secured by an owner occupied building. Similarly, the documents provide for securing loans through a variety of techniques and assets, including real estate, securities, rents and other income, guarantees, and ancillary contractual documents such as leases, construction contracts, building permits and architectural contracts.

The documents prepared by the legal advisor draw upon the basics of international practice and have at least some foundation in the Russian law, though in many instances the practices embodied in the documentation are not now used by Russian banks, and in some cases may be far beyond their contemplation. It was the intention to provide relatively advanced models based on international practice, both as an instructional device and expecting that these forms will lead Russian banks and their lawyers to explore possibilities and use or modify the materials provided, as appropriate.

### *4. Advice on Commercial Real Estate Transactions*

Where necessary, the legal advisor consulted with the Pilot Banks on specific legal issues and documentation of CRE transactions. Meetings with Pilot Banks did more than provide legal advice on problems in actual transactions, and covered a broader range of legal issues concerning securing loans with CRE, as noted above.

### *D. Intellectual Leadership*

The Intellectual Leadership component focused on identifying techniques that might be used in Russia to increase the flow of funds for CRE transactions. The initial research was conducted in order to understand and evaluate the mechanisms used to finance CRE transactions, determine who was providing these mechanisms and for what purpose, and then evaluate the pros and cons of using these mechanisms over the short and longer term. The next step was to evaluate new mechanisms financial institutions might use to finance CRE transactions, whether financial institutions could use the new mechanisms in Russia today, what obstacles existed to using the new mechanisms, what would have to be done to eliminate those obstacles, and the probability of successfully overcoming

the obstacles. In addition to identifying new, usable mechanisms; the work would consider other mechanisms considered but discarded for clearly defined reasons, and suggest ideas that might be used if certain obstacles were addressed and define how to address those obstacles.

The Team's Corporate Finance Advisor met with numerous institutions in Moscow, St. Petersburg and Irkutsk, including domestic and foreign financial institutions, real estate developers, investment funds, government officials, the securities regulatory agency, and insurance companies, to identify the types and sources of funds currently financing commercial real estate development and the obstacles to additional funds being attracted to the market (See attached table). The findings from his work appear in Part II

The Advisor identified two potential mechanisms that could be used to finance CRE transactions, one that can be initiated by the pilot banks, and one that could be initiated by the government - Pooled Equity Funds and seller finance. Respectively, the Advisor focused on the Pooled Equity Fund concept since, for reasons explained in the next chapter, it was unclear whether municipal or oblast governments had the financial ability to provide forms of seller finance.

The Pooled Equity concept was a rather simple idea that would allow banks to mix debt and equity and "pool" other funding sources together to reduce the exposure risk banks face by lending to commercial real estate projects. Pooled Equity would bring more financing to a project and increase the likelihood of completion, would reduce a project's dependence on advance lease payments that deplete operating cash flow after lease-up, and would result in lower debt service in the early years, during the lease-up stage, because less debt financing was used. The banks could include one or many projects in the fund to diversify their investments and credits.

The Advisor developed a short training brochure on pooled equity funds to educate bankers, other financial institutions, government officials, and enterprises on the concept. Several Pilot Banks were eager to develop such funds to satisfy the CRE financing demand of their customers.

#### ***E. Project Cooperation***

The overall land reform strategy developed by USAID and the short intensive nature of the project required close cooperation and coordination with other USAID projects. All the projects were targeted to address different obstacles in facilitating the rapid development of the market and were inter-linked to compliment and build upon each other to provide for a more efficient and effective means of accomplishing the goal.

USAID and the project managers regularly met to increase the efficiency and effectiveness of the projects, and to ensure an ongoing dialogue and information exchange. Working closely with the other privatization projects avoided the duplication of efforts, e.g., legal work in the area of title and mortgage registration. Moreover, it provided the team with background information and intelligence that allowed technical assistance to move forward on time and in an orderly fashion. This fostered a team spirit among the contractors that facilitated cooperation. The table on the following page sets

forth the primary contractors that interacted with the team, the purpose of the coordinated efforts and the activities of their joint work.

By working together, these projects were able to accelerate the Government's aims to improve land use, and to facilitate development of private land and commercial activity in the cities. The purpose of cooperating was to enable purchasers of commercial properties to finance acquisition of land, buildings and other structures (ELS and Housing Reform), to improve local infrastructure (REIS, Title Information) and to stimulate private investment in various economic sectors of the country (Public Information). The following shows how each of the joint activities addressed these aims.

*Enterprise Land Sales.* The rationale for working with ELS was to facilitate the transfer of land from local governments to privatized business enterprises via bank financing. Surveys performed by ELS showed that 50 - 75% of the enterprises purchasing their land would require financing for the acquisition. The Barents Team assisted several enterprises in making initial contact with the Pilot Banks, effectively using the relationships the team established with the Pilot Banks. This link provided an initial source of information for the enterprises' prospective CRE financing. The Pilot Bank loan officers were trained in analyzing CRE transactions and the ELS staff and officers of the privatized enterprises also benefited by learning basic CRE analysis techniques.

The publication, "How to Develop a Loan Proposal", outlined the necessary information to include in a loan proposal and the purpose. The lack of understanding on the part of the borrower regarding the type, amount and purpose of information to submit was a major problem faced by the Pilot Banks. After the Bank's loan officers were trained, they oftentimes served as consultants, assisting their customers, privatized enterprises, in compiling and organizing the necessary information and advising them on how to develop and format a business plan.

Another outcome of the cooperation with ELS was to facilitate the awareness of the Pilot Banks on the importance of intermediaries, i.e. brokers. In a market economy, brokers pre-screen and facilitate transactions, putting deals together in a structure and presentation format palatable for all parties. Brokers, especially, in St. Petersburg were assisted in how to identify strong projects for Pilot Banks and in how to present themselves professionally to the Pilot Banks, customers and the public.

*Housing Reform.* Working with the same group of banks as the Housing Reform project allowed for synergistic benefits for both projects in facilitating property transfers with bank financing. Once the personnel were trained in basic residential mortgage and construction lending principles, the next step was to build on the basics with training in CRE transactions. These banks proved more likely to make CRE transactions given their favorable experience with residential mortgage loans. With the additional knowledge gained in this program, banks could apply the new techniques to residential mortgages, as well.

The Urban Institute planned on managing the project "roll-out" to an additional set of Russian Banks. Training of its staff prior to the "roll-out" assisted in laying the groundwork for a successful transition.

*Real Estate Information Systems and Title Registry.* By combining efforts, the infrastructure necessary for CRE mortgage lenders was addressed in both the title registration and the real estate information systems. This was important to help mitigate risks of financing with respect to insuring and perfecting real estate collateral.

Contract	Purpose of Cooperation	Activity Relationship
Enterprise Land Sales (ELS), Chemonics/PADCO – to assist local government in developing procedures to transfer land to the enterprises occupying the land	Assist in land transfers from governments to private enterprises via financing	<ul style="list-style-type: none"> <li>Worked with ELS and private enterprises in St. Petersburg and Irkutsk to assist with their mortgage loan applications to Pilot Banks.</li> <li>Provided training in CRE Transactions, CRE Appraisal, and Mortgage Financing for ELS field officers.</li> <li>Met regularly with ELS regional managers to understand the demand for financing in their regions.</li> <li>Met with ELS regional managers to share information regarding different methods for financing CRE transactions.</li> <li>Co - sponsored a publication developed by the Riggs Bank of Washington, D.C., “How to Develop a Loan Proposal”, outlining the necessary information to include in a loan application.</li> </ul>
Housing Sector Reform Project, Urban Institute – designed to spur housing privatization by developing the bank infrastructure to provide financing for individuals to purchase their residences	Work with banks to further develop residential and commercial mortgage lending	<ul style="list-style-type: none"> <li>Insured the CRE Manual material complimented their existing manual on housing loans.</li> <li>Exchanged progress reports about activities with the Pilot Banks.</li> <li>Coordinated visits to avoid confusion or excessive stress on the Mortgage Department of our pilot banks.</li> <li>Exchanged information on important local activity, laws, decrees, and coordinate comments on national laws.</li> <li>Ensured a smooth transition from Barents to UI for the roll out program, by providing project materials and training UI staff via the CRE training courses.</li> </ul>
Real Estate Information System Project, Arthur Andersen /Chemonics, and Title Registration System, PADCO – to spur the development of land and real estate markets by creating a title registration system and an integrated and reliable real property information	Create an information system to facilitate a unified real estate registration system useful for creditors of real estate	<ul style="list-style-type: none"> <li>Provided written requirements for a commercial mortgage registration to Arthur Andersen for St. Petersburg, a REIS/Pilot City.</li> <li>Critiqued a PADCO demonstration of a proposed software registration system for Irkutsk, a non-REIS/Pilot City.</li> </ul>
Public Information and Education, Chemonics - to inform the public on issues and developments in land reform	Develop communication strategies to support CRE financing and training initiatives and to distribute CRE information	<ul style="list-style-type: none"> <li>Prepared an article for September 1996 publication describing why banks require information before considering financing.</li> <li>Published an article about owner occupied financing.</li> <li>Published a brochure on, “How to Develop a Loan Proposal”, distributing it to 25,000 enterprises throughout Russia.</li> </ul>

For cities that REIS chose as pilot cities, the Team detailed the data that was necessary to register a commercial mortgage. For non-REIS cities, like Irkutsk, the Team investigated a prospective registration system, developed by PADCO, and confirmed that the system under consideration to register property, would properly register commercial mortgages and information necessary for financiers' decision making processes. The system demonstrated a clear ability to record, store and exhibit critical commercial mortgage information for a given property. The needs of the mortgage lenders were satisfied with this software.

*Public Information and Education.* The joint efforts of these projects were to stimulate private investment by banks in various economic sectors of the country. These efforts included developing and publishing materials to address concerns voiced by the Pilot Banks in providing financing to newly privatized enterprises. These concerns focused on communicating with potential borrowers the needs of Banks in obtaining the necessary information to evaluate a loan proposal. The materials were a means to educate the public and potential borrowers and assist the Banks in the loan application process.

### **III. Strengths and Weaknesses**

#### **A. Strengths**

In our view, the main impacts or strengths of the Project were that it developed banker skills for conducting CRE transactions, emphasized the relationships among real estate market participants and banks, raised general awareness of and interest in doing CRE transactions, and provided research and analysis on the market for CRE financing.

##### *1. Developed banker skills*

The Project improved the skills of the pilot banker on three levels -- by providing bankers with a deeper understanding of the CRE business, providing bankers with the procedural capabilities for underwriting, issuing and monitoring CRE transactions, and providing bankers with practical advice on specific and actual transactions.

- a) Deeper understanding of CRE transactions -- Bankers, especially those from the pilot banks, have a better understanding of the principles behind commercial real estate lending and are now more comfortable with issuing loans secured by CRE. At the onset of the project, there was a general interest in CRE transactions, but it was a cautious interest. Few, if any of the banks we visited during the pilot phase of the project were willing to agree to review, let alone issue, CRE loans during the course of the project. However, through our discussions with the banks' employees and by providing them with the needed knowledge, skills and resources to better mitigate the risks associated with CRE lending, by the close of the contract, four of the five pilot banks had identified and analyzed CRE transactions and one bank had issued a CRE loan.
- b) Procedural Capabilities -- Through the courses, the manual and the on-site bank visits, the Team was able to provide members of the pilot banks with the

procedural capabilities to identify, analyze, issue, and monitor commercial real estate transactions.

- The courses walked the students through the theoretical processes of analyzing, appraising, issuing, monitoring CRE transactions and provided them with actual projects in the form of case studies for the bankers to test the information they had learned.
  - The Manual provided the banks with standard policies and procedures that should be adopted by the CRE division of a bank in order to establish the appropriate checks and balances within the institution to mitigate the risks of CRE lending. The Manual also provided the banks with standard legal documentation that will protect the bank's interest should a customer default on a loan.
- c) Transaction advice -- As we mentioned earlier, at the onset of the project, although the pilot banks were very interested in being trained on the procedures for conducting CRE transactions and receiving all of the documentation we could provide, they were quite reserved in their commitments to actually work with the Team to identify, analyze and possibly issue commercial real estate transactions. However, as the project proceeded, almost all of the pilot banks took advantage of the Team's expertise and actually brought entire deals or pieces of deals to the attention of the Team and requested their advice and/or assistance on how to properly analyze the transaction. The Team provided the pilot banks with a mentoring system where the Team assisted the bankers in walking them through some of the thought processes an experienced CRE lender may use in evaluating and/or structuring a transaction.

2. *Emphasized and helped develop important relationships between bankers and other real estate institutions*

Banks should not be seen as independent entities in financing for CRETs. Rather they should work closely with other real estate institutions, such as developers and brokers, and other financial institutions in identifying and financing these transactions. The project assisted pilot banks in understanding the important role these entities can play in CRE lending and peaked their interest in working with them.

- a) Making connections to other real estate brokers and developers in identifying transactions: Real estate developers and brokers are new in Russia.
- Developers. Developers (often construction companies) are an important part of the equation as they identify profitable commercial real estate ventures, determine the type and level of demand for commercial real estate, organize the building of a project to satisfy those demands, and help locate funding sources. They are a common feature in a market economy and are becoming increasingly important in the Russian real estate market, as the need to satisfy real estate users becomes a basis for the success and profitability of a real estate project.

With the emergence of a market economy, banks now have to be concerned with the demands of users, the creditworthiness of the construction company,

and the profitability of the overall project. Working closely with developers can help assure that these ends are achieved for the bank. Through a well structured business proposal, the developer can provide the bank with the rationale for financing a project, indicating market demand and the developer's ability to organize the construction and then lease or sell the space.

This Project assisted in building bridges between the pilot banks and real estate developers by meeting with both Russian and Western developers to understand their ideas on the market and the potential involvement of Russian Banks in their transactions. The Team also discussed with the Pilot Banks the importance of teaming with a good developer who has the necessary sophistication to conduct the needed market research to truly understand the market demand for a project, develop a business plan that accurately reflects the real costs and anticipated revenues from project, and has the organization to either hire a construction company or is able to construct a quality product that meets all the standards proposed in the business plan.

In St. Petersburg, the Team worked with a developer that was bringing several projects to one Pilot Bank. We reviewed the business plan with the bank to help them understand the problems associated with the plan, including the lack of market research, the fact that the company was using indexed numbers rather than actual costs, and the need to have strong marketing information to attract other potential investors. The bank conveyed their concerns to the developer which in turn, revised the plan, taking into account the bank's suggestions, and submitted a revised, more accurate and better plan to the bank.

- **Brokers.** Brokers, play an integral role in most market economies serving as an intermediary between the lender and the borrower, assisting the borrower to find financing for a good project and bringing good project to lenders. They are often key negotiators in bringing both sides to agreement in order to move a project forward. However, in Russia, these intermediaries are brand new to the market place. Initially our Pilot Banks did not see a need for this participant and did not trust the information the intermediary provided. However, the Team was able to help them understand that Brokers play a vital role in the real estate markets because they are often able to bridge the gap between a potential borrower and a financial institution.
- b) **Making connections to other financial institutions:** We believe our work educated banks and convinced them of the need to consider financing CREs in conjunction with other financial institutions. As banks learn about funding CRE transactions they have come to understand the importance of sufficient and substantial up-front equity in projects. They have also learned the benefits of syndicating debt. As a result, banks have learned that by bringing in other financial institutions and funding sources, risks can be diversified. There are several levels of collaboration, where the banks have begun to cooperate, with international financial institutions, with pooled equity sources, and the local governments.

- International financial institutions. By working with IFI's, the banks pre-screen transactions and then share in the financing of CRE transactions, based on the IFI's financing criteria. Many transactions have been arranged this way through multi-lateral and bi-lateral financial institutions, such as the European Bank for Reconstruction and development and the US-Russian Investment Fund.
- Pooled equity. Banks are depending on the sponsors of CRE transactions to bring in more equity up-front. Investors can pool equity into joint stock companies, joint stock funds or investment funds to obtain the benefits of investing in CRE that is professionally managed, while diversifying their risks. This reduces the risks to lenders, as well, as the larger portion of the total financing is from equity investors.
- Local governments. As governments at all levels, municipal, oblast and national, have a stake in the economic success, these governments are influencing the necessary infrastructure to attract CRE development. For instance, Moscow City government is promoting municipal bond financing to develop the central business and historic district. This financing is being serviced through banks that have an interest, as well.

This approach may be able to help interested financial and real estate institutions deal with some of the obstacles in financing CRETs.

*3. Raised general awareness of commercial real estate among borrowers, lenders and other real estate market participants.*

The Project was able to raise the general awareness among potential borrowers and real estate market participants of commercial real estate transactions and the ability to use banks to generate financing for these transactions. Although we believe we were able to see a bit of increased awareness in Moscow and with our Moscow banks, the main areas of impact were in St. Petersburg and Irkutsk.

When we began the Project, Moscow was already in the midst of a large real estate boom, the effects of which were already allowing for a natural development of market participants and general insight into how to provide financing for transactions. At least one of our pilot banks had already made a firm commitment to the market and seemed to have a set plan on how to further develop the business. This same boom and general knowledge level had not yet taken place to this extent in either St. Petersburg or Irkutsk, which allowed for a visible increase in discussion and activity regarding commercial real estate generating from our project and the natural development of the market. One could look at the effects on three levels, borrowers, lenders and government.

*Borrower.* On the borrower level, the increase was accomplished in large part by our cooperation with the Enterprise Land Sales Project (ELS) and discussing the potential of providing financing for such transactions through commercial banks. The Team met and worked with several enterprises in St. Petersburg and through a new intermediary, a real estate broker, brought the transactions to the Pilot banks for potential financing. Even though the several of the enterprises were large clients of the pilot banks, the enterprises

had not previously considered approaching the banks for financing, assuming they would not be able to financing at a rate interesting to the enterprise. The Team discussed with the enterprises how to structure the transaction and how to present the information to the bank for consideration. We discussed:

- The importance of providing the banks with a business plan that describes how the enterprise would generate the income to repay the loan, whether it be through current cash flow, developing income producing properties, or resale of the land.
- When developing land, the team would suggest the company hire an expert to assist the enterprise in conducting a market and feasibility study and drafting a plan for the project development.

The Team was able to have an impact in Irkutsk as well, but as the privatization transactions are not as far along as in St. Petersburg, the Team could only discuss the possibilities with the ELS representative and bring the list of companies slated to purchase their land to the Bank. However, even at this level, we have still brought to the attention of the enterprise the viability of bank financing for CRE transactions.

*Lender.* The project was able to select only four and later five banks to work with on this pilot project. However, our work with each of these five banks has, both through the materials we developed and the increased understanding of the bankers on how identify and conduct CRE transactions, and the advantages of having such transactions in a banks portfolio. The project tried, wherever possible, to include non-pilot banks in the project and distribute information on real estate related issues to the general real estate public. Several non-pilot banks and representatives from other market participants attended our training courses. Through our cooperation with the Public Information project, we were able to publish articles and send general mailings that discussed commercial real estate and impediments that exist to its further development. The Team also spoke at several mini-conferences about the project, its objectives and accomplishes to further generate interest in our project and commercial real estate transactions in general.

*Government.* Increased government awareness and support for commercial real estate development was seen, most expressively, in Irkutsk. Due to the smaller size of the city and the tight connections between the bank and the government, the team was able to meet regularly with governmental officials to discuss the importance of CRE development, understand the cities priorities for development and explore potential government sponsored programs to spur development in the region. There was quite a visible increase in the amount of discussion between the bank, potential investors and the government on different methods for promoting and financing CRE development.

4. *Conducted research on the commercial real estate market, the demand, supply and obstacles to financing, and the legal constraints to commercial real estate lending. Wrote papers on these issues that can serve as resources to individuals who read them.*

*Commercial real estate market.* Throughout the project, the Team has increased its depth of understanding of the commercial real estate market by meeting with market participants and working within the banks to increase their capability to conduct CRE

transactions. Our Corporate Finance Specialist conducted research throughout the project into the demand and supply of financing in the market and the obstacles that are inhibiting a greater flow of funds to the market. Through this work, he developed a rather simple, but new option for financing commercial real estate transactions to our pilot banks and other real estate market participants. The project developed two papers discussing the demand and supply of financing for commercial real estate and a brochure on the development of pooled equity funds that are available for distribution to individuals interested in the information.

*Legal constraints.* Although we were not able to greatly impact the current legislation and pending legislation for regulation of commercial real estate financing in the short duration of this contract, the Team did submit recommendations for modifications and additions to the legislation to help protect the interest of the banks. Throughout the project, the Team developed a good understanding of the legal concerns of banks with regard to financing transactions, combined this with international standards when drafting the recommendations. In addition our legal advisor wrote a paper addressing the weaknesses that currently exist in the proposed legislation, explaining why these weaknesses are of importance and suggesting ways for banks to continue protecting their interest while financing transactions if the legislation were to pass as is.

#### *Weaknesses*

The areas where the project was able to contribute the least were the broader, so called, “environmental” issues. One of the concerns early on in the project was whether the market was ready for the project, and whether we could accomplish the needed objectives given the current environment in Russia e.g. the lack of long-term funding, high interest rates, and legal obstacles. Although we strongly believe that the timing was right and that we were able to accomplish as much or more than what was initially expected, the obvious places we were able effect the lease were these “environmental” issues.

Clearly the high interest rates, competing investments and the lack of long-term financing have political and economic implications that are far beyond the scope of the project. While we could not affect these conditions directly, we hope that the work we have done with the banks will make it easier for them to properly analyze and structure transactions in this environment and that we have provided them with the knowledge, skills and tools to expand their involvement in the market as these factors decrease. We also hope that our pooled equity approach will help the bank find and structure financing for CRE by augmenting its financing ability and spreading the project exposure.

With regard to the legislation regulating the CRE finance market, the national legislation governs this area. Although the Team was able to identify the gaps in the laws and regulations that specifically affect CRE and make suggestions to the draft mortgage Law that we hope will be incorporated into the next draft, as mentioned earlier, our ability to really affecting change over the course of the project was quite limited.

#### **IV. Conclusion**

The Project was able to lay a strong foundation for providing financing for CRE transactions -- in understanding the business, developing the necessary skills to conduct prudent transactions, and raising awareness about and interest in commercial real estate and using banks to finance the transactions. This foundation was laid at an opportune time, as the demand for real estate financing is rising with economic growth and activity in Russia.

At the same time, the obstacles that existed at the start of the project are still constraining the supply of financing. But as mentioned previously in this paper, these obstacles are too political and broad in nature to be greatly affected in the short time frame of this contract. However, it is the general consensus that these factors are changing. Banks are starting to test the waters of financing commercial real estate and the pilot banks are now properly prepared to enter this market. Easing into CRE financing not necessarily a bad approach. As the market becomes more favorable, the banks can begin to increase their activity to stay on top of this growing market.

*APPENDIX A*

## **Training Materials and Other Tools Provided to the Pilot Banks**

### ***A. Training Materials Developed***

- Commercial Real Estate Policies and Procedures Manual
- Three Commercial Real Estate Training Courses
  - Commercial Real Estate Lending
  - Commercial Real Estate Workshop
  - Commercial Real Estate Appraisal
- Commercial Real Estate Appraisal Manual
- “How to Develop a Loan Proposal” Brochure

### ***B. Excel Based Software Models Developed***

- Discounted Cash Flow Projection and Net Present Value Spread Sheets
- Profit and Loss Balance Sheet Analysis
- Construction Budget Requisition Forms

### ***C. Other Tools Purchased from the U.S. Market Purchased for the Pilot Banks***

- Commercial Real Estate Valuation Software Designed by Argus
- “Income Property Appraisal Analysis” by Friedman and Ordway
- Four Manuals from the Society of Real Estate Appraisers
  - “A Guide to Appraising Industrial Property”
  - “Shopping Center Appraisal and Analysis”
  - “The Office Building -- From Concept to Investment Reality”
  - “Hotels and Motels -- A Guide to Market Analysis, Investment Analysis and Valuations”

*APPENDIX B*

**REMAINING ISSUES AFFECTING MORTGAGE LENDING FOR COMMERCIAL  
REAL ESTATE IN THE RUSSIAN FEDERATION**

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**AUGUST 27, 1996**

The pending Russian Federation Law On Mortgage (Pledge of Real Estate) (in this report referred to as the "Mortgage Law") is a further step in development of a system of real estate mortgage lending.<sup>1</sup> However, the pending law either fails to address or addresses in an ambiguous way a variety of issues that likely will have to be resolved over time. This report provides an overview of the significant issues affecting mortgage lending for commercial property.

Both the Mortgage Law and the Law On Registration of Rights to Real Estate are on the legislative agenda at this time. The Law On Registration of Rights to Real Estate has had a successful third reading on July 19, 1996 and will await transmission to the Federal Council, the upper chamber of the Russian national legislature. The Mortgage Law has had a first reading and likely will have the crucial second reading in the Fall.<sup>2</sup> While the final forms of these laws may be sufficiently clear at this time that some comments are possible, changes can be made between now and final enactment.

Considering the advanced stage of these laws and apparent consensus that they will be enacted in some form, this report does not dwell on the deficiencies in the current legislation but rather assumes that the Mortgage Law will be enacted in its present form. Upon enactment of the Mortgage Law, the laws governing mortgage lending will be the Civil Code and the pending Mortgage Law. The relationship is such that the Civil Code sets out general principles which may be modified by the Mortgage Law - that is, in an approach which is unusual for Russian law, the general principles of the Civil Code relating to pledge of land, buildings and structures will be only in the absence of a specific contrary rule in the Mortgage Law or in the Civil Code itself. Thus, the Mortgage Law will be the first source of law for commercial real estate mortgage lending, and the Civil Code will come into play only to the extent that questions are not answered in the Mortgage Law.

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<sup>1</sup> All references are to the draft of the law submitted to the State Duma by deputies I. D. Grachev, P. D. Bunich and deputy of the first State Duma G. I. Zadonsky.

<sup>2</sup> The Mortgage Law actually received its first successful reading in the prior Duma. At this time there remains the possibility that that reading will be viewed as not binding on the present Duma and the process will begin again with a first, and not second, reading.

## OPEN ISSUES

### 1. LEGAL EFFECTS OF FORECLOSURE

The Mortgage Law does not clarify the legal effect of foreclosure on several types of third-party interests which may attach to real estate.<sup>3</sup> The law addresses the effect of foreclosure on the following interests:

- Overlying mortgages - if an underlying mortgage is foreclosed, overlying mortgagees may share in the sale proceeds to the extent that any proceeds after payment of the prior mortgage(s). The implied principle is that this is the main remedy available to the overlying mortgagee, and that the overlying mortgage is terminated by foreclosure sale of the property. However, there is no clear statement that the unsatisfied overlying mortgage is in fact terminated, and the law is sufficiently ambiguous that the opposite conclusion could be drawn.
- Leases - the proposed law states that leases are terminated if they are signed without the permission of the mortgagee after the effective date of the mortgage.
- Servitudes - the law states that servitudes created by private contract after the mortgage without the consent of the mortgagee are terminated by foreclosure and sale of the property, implying that such servitudes created prior to mortgage will survive foreclosure and sale. Moreover, since under Russian law servitudes may be created by order of court, it seems possible, even likely that a servitude so created will survive foreclosure and sale regardless of whether created before or after the mortgage. However, the issue of the priority of court ordered servitudes is not clearly addressed yet.
- Beneficial rights of occupancy - in the case of residential property, the occupancy rights of family members survive foreclosure sale unless the mortgage loan is for the purpose of acquiring or constructing the dwelling and family member agree in writing to relinquish their rights at the time the mortgage is made.

Third-party rights which are not addressed include, for example, the following:

- Unwritten and unregistered rights, generally<sup>4</sup>
- Rights of use, economic and operational management

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<sup>3</sup> The term foreclosure is used here to refer to completion of an auction sale of mortgaged property pursuant to court order or acquisition of the property by the mortgagee following two failed auction sales, as permitted in the law.

<sup>4</sup> The issue of unregistered rights may be addressed in the Law On Registration of Rights to Real Estate, which provides that registration of rights to real estate is obligatory and failure to register nullifies the right as a matter of law. Nullification in this case is generally interpreted to mean that the right is ineffective as against any legally existing right, including a mortgage.

- Options and other preferential rights
- Preliminary contracts for purchase and sale
- Judgment liens and other attachments arising by law or court decision
- Taxes and other public burdens
- Servitudes established after the effective date of the mortgage
- Beneficial occupancy rights of minor children

To address this issue it is recommended that the law include a general principle that legal foreclosure results in termination of all third-party interests created without consent of the mortgagee after the effective date of the mortgage if the holders of the interests have had legal notice and the opportunity to participate in the proceeding. Limited exceptions could be made for taxes and other encumbrances of a public nature affecting the mortgaged property, and perhaps for court ordered servitudes. Although not specifically relevant to commercial property, the occupancy rights of minor children in residential property should be subordinated to the rights of their parents.

## **2. LEGAL EFFECTS OF NEGOTIATED SETTLEMENTS**

The law will allow mortgagees to acquire the mortgaged property by written and notarized agreement after the grounds for foreclosure arise. The property would be transferred to the mortgagee by purchase and sale agreement. Notice to third-parties of the negotiated settlement is not required, and the law is ambiguous on the surviving rights of third-parties after negotiated acquisition by the mortgagee.<sup>5</sup>

The benefit of foreclosure and public sale is that it requires notice to interested third-parties and provides them with an opportunity to appear and protect their interests. Accordingly, some laws provide that a negotiated acquisition of mortgaged property by a mortgagee does not terminate third-party rights to the mortgaged property.

It is recommended that the law clarify the rights of third parties under the various forms of mortgage enforcement permitted in the law - judicially supervised auction sale, private auction sale, and negotiated acquisition. The strongest arguments can be made that only enforcement through sale procedures requiring notice to third-parties should result in termination of third-party interests, and that third-party interests survive negotiated acquisitions by mortgagees.

It is further recommended that the law provide that upon negotiated acquisition by mortgagees the mortgage should be deemed to continue in effect until its maturity, or for

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<sup>5</sup> The law provides that a negotiated settlement agreement must identify third-party rights, but does not specifically say that they survive the negotiated acquisition by the mortgagee.

some other specified period, which would allow the mortgagee to bring an action of foreclosure to terminate subordinate third-party rights.

### **3. POTENTIAL DELAYS IN FORECLOSURE PROCEDURES**

There are several aspects of the mortgage law which may cause delays in executing on mortgages. The risk of delays are well known, and include deterioration of the property, deterioration in property markets and increased likelihood of further interest losses from a bankruptcy filing or inability to obtain a deficiency judgment from an insolvent borrower.

The main impediments to effective mortgage foreclosure in the proposed law include the following:

*Mandatory judicial foreclosure.* The law requires most mortgage to be foreclosed through judicial procedure. Non-judicial procedure - essentially private sales or transfer of title to the mortgagee - may be permitted only pursuant to a notarized agreement of the borrower and lender executed after the claim for enforcement arose, and this remedy is not available if the mortgage was concluded with the consent of another person or administrative body; is a mortgage of an enterprise complex; is a property of historic or architectural value; or is commonly owned and one or more common owners object.

The limitations on use of non-judicial enforcement may be particularly pertinent to commercial lenders because it is not permitted if the mortgage itself required the consent of another person or administrative body. This is likely to include most mortgages on lease rights which under the present law may be mortgaged only with the consent of the owner of the property, which in many cases will be the state or a municipality. The law apparently requires judicial foreclosure in any case of mortgaged lease rights, and this is an absolute requirement which cannot be circumscribed by having an owner give his consent to non-judicial enforcement at the time the mortgage is made.

Also important in some localities may be the prohibition on negotiated enforcement of mortgages on historic properties. In St. Petersburg, for example, where much of the real estate in need of private investment in the center city is of historic significance and the privatization process of such structures has been approved and will commence in the near future.

Finally, the definition of an "enterprise" complex is not clear at this time. For example, most real estate projects are undertaken by single-purpose legal entities created solely for the purpose of constructing, owning and operating a large project. In effect, such entities are enterprises in and of themselves. If defined as such, this law may prevent non-judicial enforcement for most large real estate projects.

Perhaps most troubling at the moment is that the law presently under consideration prohibits the mortgagee from negotiating an acquisition of the mortgaged property if the property consists of "land plot, structure, residential house or apartment." Since this effectively includes all real property, it seems to rule out any negotiated acquisition - in effect taking away with one hand what is given in another. We are advise that this is a

misunderstanding, and that the limitation was meant to apply only to agricultural land plots. However, this proviso will have to be followed.

Many, but by no means all, legal systems allow for some expedited procedure for foreclosing on mortgage loans short of a full blown court hearing. This is the case, for example, in about 25 of the American states, which allow for sale of property by a power of sale granted directly to the mortgagee or to a trustee which acts in the interests of the mortgagee. Other jurisdictions which do not allow non-judicial enforcement of mortgages provide for some form of expedited court proceedings for mortgage foreclosure, defining the issues which may be raised in the procedure and the manners and burdens of proof of the parties.

It is recommended that the usefulness of the non-judicial enforcement procedures of the law might be improved, particularly for commercial project lending, by considering the following:

- Clarify that owners of leased property which is mortgaged by the lessee can consent to non-judicial enforcement at the time the mortgage is made.
- Except from the definition of "enterprise" for purposes of the law any legal entity created solely to acquire, construct, own and operate a real estate project as an investment.
- Except from the limitation any project of historical or architectural significance on which restoration has been completed in accordance with an agreement with the owner. Such agreements generally provide for long term maintenance obligations which are binding on all subsequent owners of the property and should not be affected by a mortgage foreclosure. If the maintenance agreement is violated the municipal authorities have other remedies against the new owner.
- Delete the present prohibition on negotiated acquisition of "land plots, structures, residential house or apartment."

*Court Intervention.* The proposed law as well as the Civil Code permits the court, upon motion of the mortgagor, to delay enforcement of a foreclosure judgment for up to one year from the date of judgment if the mortgagor is a natural person and a citizen of Russia, except if the mortgaged property is used in business or agricultural production. Execution of judgment on business property may not be postponed at all, and execution of judgment on agricultural land may be postponed regardless of whether it is owned by a natural person or legal entity. However, under no circumstances may the postponement be ordered if to do so would cause significant worsening of the financial status of the mortgagee with respect to the mortgaged property, or if bankruptcy proceedings are commenced against either the lender or the borrower. The postponement of enforcement does not relieve the borrower of any financial obligations, including any increase in debt or losses that accrue during the period of postponement. If the debtor satisfies the lender's claims within the allowed period of foreclosure the judgment will be terminated by the court.

This provision resemble in many respects the statutory redemption periods provided by the laws of many American states. (It is often heard that such redemption periods were devised for the protection of farmers who were given at least one more growing season to try to make good their debts; the inclusion of the reference to agricultural land shows perhaps some familiarity with the purposes of the original laws.) While they are inconvenient for lenders, their actual effect on lending is difficult to determine. With respect to commercial lending, the provisions of the proposed law have several favorable aspects, including:

- The postponement may only be sought by natural persons, and not if the property is a business property. It seems unlikely that the one year postponement would be allowed, for example, to the owner of a investment such as a commercial office building.
- The court may not grant the postponement if there is a bankruptcy filed against the debtor, and may consider whether the postponement would worsen the financial position of the lender.

One potential ambiguity in these provisions of the law is whether the borrower is permitted to reinstate the mortgage, and not simply repay the indebtedness. It appears that because the redemption period follows the judgment on the indebtedness the intention is simply to allow redemption through payment of the entire outstanding debt. This question may be affected by the interpretation of the provisions on acceleration of the loan, discussed elsewhere in this report. However, it is recommended that the law might be clarified by stating that the mortgagor is entitled only to pay the amounts of the judgment, and not reinstate the mortgage by bringing his payments current.

The possibility of the court exercising its jurisdiction to delay enforcement of a judgment on the debt is probably not very great for commercial mortgage lenders, as in most instances the borrower will be a corporate entity or the property will be used for business purposes, two situations in which the one year postponement of enforcement may not be applied. However, to the extent that agricultural lending is a distinct type of commercial lending, mortgages made on agricultural land may be, and often likely will, subject to the one year delay of execution. However, this may be the least of the problems affecting mortgage of agricultural land.

#### 4. APPEALS

All judgments of lower courts are subject to appeal. Though this is not specifically provided in the mortgage law it is a basic premise of the civil legislation and the laws of civil procedure. Moreover, the statute of limitations for appeals can be as long as three years following the judgment. While the possibility of appeal is endemic in all legal systems, and affects mortgage actions along with all other civil judgments, in Russia the possibility may cause more concern for several reasons:

- There is no clear indication in the law as to how the bona fide purchaser at an auction sale will be affected by an appeal of the foreclosure judgment; the likely conclusion under the law is that the foreclosure would be unwound and the purchaser be reimbursed for his expenses by the mortgagee; but there is no clarity on this issue -

for example, whether the purchaser is entitled to reimbursement for interests and any amounts expended to improve the property.

- There is little understating of the new law, and the grounds for legitimate appeal may be very broad right now; particularly worrisome is the possibility of allegations of fraud made against lenders.<sup>6</sup>
- The foreclosure procedure itself is complex and there is limited experience with it; the likelihood of appeal on procedural grounds may be high.

For these reasons, the possibility of appeal may pose a serious obstacle to efficient enforcement of mortgage foreclosure actions in Russia.

It is recommended that to minimize the risk of appeals of foreclosure judgments the following steps may be considered:

- If execution of judgment is to be delayed pending appeal, prevent frivolous appeals by requiring the mortgagor or other claimant to file an appeals bond which guarantees to the mortgagee any losses of interest or other expenditures for loss of value of the property pending appeal;
- Reduce the statute of limitations for appeals of foreclosure judgments from the present 3 years to 6 months;
- Provide for an accelerated schedule for appeals of foreclosure judgments, giving priority to such appeals. Such a policy can be justified on public policy grounds because of the need to place significant real estate assets into circulation and use; the delay of foreclosure proceedings results in uncertainty over property rights and therefore, often, deterioration of the property or failure to make improvement to the property. Moreover, pending resolution productive use is often not made of the asset, which is an economic loss to society as a whole. These issues can be particularly important with respect to foreclosures which occur during the construction process when it becomes important to settle ownership rights and complete a structure before deterioration sets in.
- If execution is not to be delayed pending appeal, it is necessary to clarify the rights of the bona fide purchaser from the auction sale or from the acquiring mortgagee. At present the purchaser appears to be entitled to receive from the successful appellant the amount spent on acquiring the property at foreclosure. However, there is no indication about what the purchaser is entitled to for interest on his investment for

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<sup>6</sup> A St. Petersburg bank participating in the commercial loan project reports that it has successfully argued a foreclosure action on commercial property all the way through the Supreme Arbitration Court. The action took one year from filing to completion. The appeal was taken first to the regional Arbitration Court before arriving in the Supreme Arbitration Court. Reportedly, at both levels of appeal the mortgagors grounds for appeal were found to be completely lacking in substance. The appeals having been taken, however, in the estimation of the responsible lawyers an action that might have been completed in three months took one year, not to mention the additional expense.

the period that he held the property, or for any improvements of a capital nature that he may have made to the property. This issue could be addressed in the mortgage law by providing that in the event that a foreclosure sale is unwound the bona fide purchaser is entitled to reimbursement from the claimant in the amount of his principal, interest at a specific market rate, plus the costs of any capital improvements which he made to the property which cannot be removed.

- Define the prima facie case for judgment on the debt in terms of the evidentiary and pleading obligations of the mortgagee and mortgagor. This will not only assist in quick resolution of actions at the trial level, but also expedite appeal by providing guidance to Russian courts of appeal that are presently authorized to consider all actions de novo.

It is important to note that many of the issues raised here are not peculiar to the Russian system. Issues on non-judicial foreclosure, redemption periods and appeals of foreclosure judgments are commonplace even in many systems, though judicial and bar experience as well as clarity of law and precedent tends to limit the impact of many of these possibilities.

## **5. PARTIES**

The premise of mortgage law is that the rights of all third-parties arising after the effective date of the mortgage are terminated by foreclosure and auction sale if the holders of the rights have notice of the action. The proposed law gives to those with interests in the property - including tenants - the right to appear in the action. Notice to such parties is provided by the court pursuant to the present provisions of the Code of Civil Procedure.

It is recommended that the law could be improved clarifying the following:

- Only parties having registered interests as shown in the registry of real estate, or whose interest arises by law, such as the beneficial rights of family members to occupy residential property, are entitled to notification of the action. This approach is the natural corollary of a system of compulsory title registration enacted in Russia, in which all interests in real property must be registered as a matter of law, and unregistered interests are deemed to be null and void with respect to competing interests. (This may in fact be the outcome of future interpretation of the law.)
- Notice to any other third-party will be deemed to have been given as a matter of law by publication in an official newspaper of a notice of the action to foreclose. (It might be noted that the possibility of such notice by publication is not provided in the draft Mortgage Law, or in the presently effective Code of Civil Procedure or drafts of its pending revision.)
- Any claim not raised at the hearing by a party with notice can not serve as the basis for appeal of the judgment.

## **6. REMEDIES PENDING FORECLOSURE**

The risks to the mortgagee of delays in execution could perhaps be lessened if there were adequate procedures for appointment of receivers or other provisions allowing a mortgagee to gain rapid possession of the property for operations and collection of rents. The mortgage law does not deal directly with the issue of receivers and collection of rents except to allow them in the case of a mortgage of an enterprise as a complex.<sup>7</sup> The Civil Code provides that the right to the fruits, rents, etc. of the mortgaged property shall remain with the mortgagor until mortgage enforcement is completed, but that in the mortgage contract a mortgagor may specifically pledge his rights to products and income from the mortgaged property. Such a pledge would provide the mortgagee with priority rights to collection of rents. Moreover, even in the absence of a specific pledge of rents in the mortgage contract, there is no apparent reason why a mortgagee could not apply to the court under its general rights as a creditor to have rents deposited into an account established with the court, or to attach other accounts of the mortgagor in which rents are deposited.

While there may be sufficient legal authority at this time to arrive at appointment of receivers and collection of rents in commercial projects pending foreclosure judgment and sale, minor additions to the mortgage law could clarify these points and provide somewhat greater protection to commercial lenders.<sup>8</sup> It is recommended that the following be considered:

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<sup>7</sup> The ability to apply for receivership in connection with an "enterprise" mortgage raises several interesting possibilities with respect to mortgages made by single-purpose legal entities created solely for the purpose of acquiring, constructing, owning and operating real estate projects. If such entities are defined as "enterprises" then appointment of a receiver would be possible.

<sup>8</sup> The Mortgage Law provides that among the issues to be decided by the court in a foreclosure proceeding are the steps, if any, to assure that the property is preserved pending sale. Conceivably, this provision could serve as the basis for appointment of receiver in the case of threatened deterioration or other misuse of the mortgaged property. On its face, it does not clearly lend itself to a claim for receivership or collection of rents, but it could perhaps do so if the rents were applied toward maintenance of the property.

The Civil Code itself contains many provisions regarding the enforcement of contracts which may be applicable to the case of collection of rents or appointment of receivers or trustees for management of property pending foreclosure sale. In the first instance, parties to contracts are bound to minimize financial damages, which may serve as the basis to move the court to provide for collection of rents and application of the proceeds to maintenance of the property and payment of interest on the debt pending foreclosure sale. Secondly, the Civil Code allows the pledge of receivable as security for a debt. It is therefore possible that a mortgagee may take a separate pledge of rent receivables exercisable in the event of default, which may be acted upon separately from the mortgage foreclosure action. While this would at least assure that the mortgagee may get access to rents, there is no assurance that the court proceeding for collection of rents would proceed any more quickly than the foreclosure proceeding.

It is likely that the pledge of rent receivables as additional security could be done in the mortgage document itself and the court moved for early judgment on the request for collection of rents, which would be effected, perhaps, through appointment of a court supervised receiver. (In fact, under the principle of consolidation of actions, the claim for rents would be consolidated with the mortgage foreclosure action.)

- Specifically allow appointment of a receiver and collection of rents pending completion of foreclosure proceedings on commercial, income producing properties, if necessary to protect the security of the mortgagee and minimize financial damages.
- Allow appointment of a receiver as a preliminary motion pending judgment on the foreclosure action.
- Specifically allow a pledge of leases, rents and other personal and movable property and equipment necessary for operation of the mortgaged property to be included in the mortgage document.

## 7. PRIORITIES

The simple matter of priorities among secured lenders - for that matter, among conflicting legal interests in the property - is addressed in the Law of Registration. The applicable principle is first in time, first in right. There remain, however, several issues which may affect the rights of commercial mortgage lenders:

*Roll overs, extensions, etc.* The Mortgage Law provides that underlying mortgages may not be amended or modified so as to increase the total volume of claims against the mortgagor without the consent of overlying mortgagees. It appears that this rule applies to term extensions as well, which do not increase the total volume of claims against the mortgagor, but simply extend the existing claim for a longer period. (It is possible to argue that any time extension which requires a greater total of interest payable with respect to the underlying loan or extends the duration of the risk is an increase in the initial claim of the underlying mortgage.)

In many instances it is possible that the interest of the underlying commercial mortgage may be prejudiced if his freedom to renegotiate all terms of the mortgage are subject to the consent of the overlying mortgagee, who may have a minor interest in the project compared to that of the underlying mortgagee. This is arguably an impractical solution to the problem, but it by no means unheard of in other systems. The American system generally provides that term extensions are permitted in any case without affecting the priority of the underlying mortgagee, and that interest rate increases and principal increases may be made if contemplated in the underlying mortgage.

As a practical matter, the law allows mortgagees to prohibit all second mortgages and to accelerate a loan for violation of the prohibition. It may be a relatively simple matter for all mortgagees to prohibit second mortgages, and to allow one only upon obtaining the consent of the second mortgagee that the underlying mortgage principal, interest rate and maturity may be adjusted without prejudice to the priority of the underlying mortgage. To deal with this issue in the law, it is recommended that the law be modified to provide:

- Term extensions do not require the consent of overlying mortgagees.

- Changes to interest rates and principal balances of underlying mortgages are permitted if contemplated generally in the underlying mortgage - that is, the risk of modifications to the risk is placed on the overlying mortgagee if he is placed on notice of the possibility. It is sufficient for the mortgagee and mortgagor to agree in the mortgage that they may negotiate increases in the interest rate and the principal amount of the loan not to exceed specified amounts.
- Permitted modifications to the terms of underlying mortgages may be made by amendment and the registration of the amendment does not affect the legal priority of the underlying mortgage if such modifications were permitted in the original mortgage document.

*Construction advances; effective date of mortgage.* An issue of priorities arises with respect to loans advanced in installments, as is the typical construction loan, or on which advance is delayed pending completion of certain undertakings or conditions by the borrower. Typically, on such loans the mortgage is registered at the start, and under many systems that registration provides priority for all future advances under the loan up to the agreed amount, regardless of intervening liens. In systems where such protection is not provided it is generally possible to review registration records to determine the existence of an intervening lien and the lender will reserve the right to terminate advances and call the loan if a problem lien exists.

The Russian law today does not explicitly address the issue of liens which take effect or are registered before the entire loan amount is advanced. The pending Mortgage Law seems to provide an answer which may be adverse to the interests of the mortgagee. That law provides at article 12 that:

1. *The rights of the mortgagee stipulated by this law and the Mortgage Agreement with respect to the property mortgaged originates at the moment of concluding the Agreement, and if an obligation secured by the mortgage arises later, from the moment of origination of such obligation. (emphasis supplied)*
2. *The property mortgaged under the mortgage agreement shall be deemed as mortgaged upon origination of the right of pledge.*

This language may be interpreted to say that the priority of the mortgage is based on the amount of the loan disbursed (the "obligation") at any point in time, allowing the possibility of intervening liens arising between loan disbursements. Contrasted to this is the language of article 3 of the proposed mortgage law which states simply that the mortgages secures to the lender repayment of the principal of the loan, without making reference to the amount of the loan disbursed at any time.

The general rule of law in many jurisdictions is that the mortgage secures only the amount of the secured obligation disbursed and owing at any given time. An exception is often carved out of this rule for loans disbursed in installments, in particular construction and

revolving loans, which says simply that if the lender chooses to make further advances under its loan obligation it will be secured against intervening liens. There is a strong public policy in favor completing projects, supported by the fact that all intervening lienors are on notice of the potential full amount of the construction loan. There is no reason to believe that the Russian approach will be different, but there is no indication in the law one way or another.

This is a serious issue for commercial lenders making construction loans. For example, the recently enacted second part of the Civil Code apparently gives to construction contractors rights to lien the property under construction and to enforce the lien in the same way as a mortgage, without stating whether the right is inferior or superior to any rights of the mortgagee. In fact, the issue is as yet unresolved. Yet, in some other legal systems, the question of the relative priorities of lender and contractor during the construction period is one of the central legal issues around which the transaction is structured. If under the Russian law it is intended that contractors rights take effect from the moment a claim is asserted, it is clear that few lenders will be willing to continue to make advances after that point. Moreover, the law is generally silent on important procedural issues, for example the obligation, if any, of the construction contractor to give written notice to the lender or file a notice of claim in the property registry.

It is recommended that the problem could be cured by a simple amendment to the Mortgage Law which provides lenders on loans disbursed in installments the right to continue to make protected advances to the full amount of the mortgage loan after an intervening lien arises, if such advances are for the purpose of completing a structure.

*Third-party interests.* While the registration law appears to be comprehensive, requiring registration of most interests affecting real estate, the issue of what interests, if any, prime a registered mortgage is somewhat undefined. The Law On registration of Rights to real Estate is discussed further in a separate section of this report.

## **8. FORFEITURE/CONFISCATION.**

A significant issue may be the general forfeiture provisions of the law which state that in the event that the property is confiscated for either civil or criminal infractions the mortgage simply terminates and the mortgage is left to a contractual claim on the loan obligation. The scope of the forfeiture penalties in Russia are not clearly defined at this time. An example is found in the land laws, which provide that continued "misuse" of the land may result in termination of ownership through forced sale to another, with payment of proceeds to the present owner, effectively placing the mortgagee in the position of junior lienor at a foreclosure sale. The same rule applies under the civil code to owners of residential buildings who violate the housing maintenance codes. In effect, the law establishes a statutory priority for the state in a wide array of potential circumstances which cannot be anticipated by the mortgagee.

There is no reason why the rights of the state should be superior to the rights of the mortgagee. It is recommended that the law provide that any property acquired by the state through confiscation for criminal or civil violations by subject to the rights of the mortgagee, in effect allowing confiscation only of the violator's equity interest in the property. The most

recent draft of the Mortgage Law finally recognized this principle, but it is a matter of some controversy and should be followed closely.

## 9. MORTGAGEE ROLE IN AUCTION SALE

Under the Civil Code the process of enforcing a mortgage lien has been governed by the Code of Civil Procedure which was enacted in 1964. That law provides a simple process of attachment, advertisement and public sale by an official of the local civil court. Some banks express reservations that the process is not clearly defined and that the courts, having little experience, are uncomfortable with the process. However, the point is arguable, as it has in fact been shown to work by several banks. The emphasis here should perhaps be placed on the experience of the local courts and their willingness to facilitate the process, which may differ among localities.

The Mortgage Law attempts to supersede the Code of Civil Procedure by including in its terms relatively detailed provisions on the enforcement process, including provisions on notice, advertisement, auction starting prices, methods of public sale, and distribution of sale proceeds. The procedures of the Mortgage Law are reasonably well designed to achieve their purpose. Nevertheless, there are certain aspects of the procedure that may have to be revisited over time as experience tells whether they work.

One issue may be the role of the mortgagee in the foreclosure sale process. Under the Mortgage Law a foreclosing mortgagee is not permitted to bid at the auction sale. The options open to the mortgagee are as follows:

- negotiate acquisition of the property with the mortgagor (“conveyance in lieu of foreclosure”);
- after the default has arisen, enter into a notarized agreement with the mortgagor providing for auction sale of the property;
- pursue the foreclosure process through the courts, and (1) after one unsuccessful auction sale, if the mortgagor agrees, purchase the mortgaged property for the full auction starting price, or (2) after two unsuccessful attempts at auction take ownership of the property for a price equal to 75% of the official starting price, in either case crediting its outstanding loan balance against the purchase price.

There are some limitations on each of these options as described earlier in the discussion of non-judicial foreclosure. It is worth noting in particular that the mortgagees’ right to take ownership of the property after two failed auction attempts is not really an option - in such cases the mortgagee must take the property or the mortgage will be terminated by the court, leaving the mortgagee with only the claim against the borrower.

The “work out” provisions of the Mortgage Law which allow conveyances in lieu of foreclosure and negotiated private sale agreements are probably useful and there is no apparent reason why they should not work. In fact, most Russian banks reveal that they have

little experience with foreclosure because most security arrangements are in fact resolved by negotiation without court procedure.

The policy behind prohibiting mortgagees from bidding in their loans is far from clear. Experience in other countries suggests that with respect to commercial properties at least, the mortgagee is often the only bidder, as the cost and complexity of large commercial projects discourages acquisition at public auction sale. Moreover, as a matter of theory, allowing the mortgagee to bid at the initial auction does not prejudice the process in any way, as the law calls for an auction starting price to be established by agreement of the parties or by the court; it can perhaps be presumed that the courts will establish starting prices so that the borrower is not deprived of his equity interest in the property.

Ultimately, however, because the mortgagee has the right, if the mortgagor agrees, to purchase the property for the starting price if the first auction fails, and the absolute right to purchase the property for 75% of the starting price if the second auction fails, the right to bid at the actual auction may be unimportant so long as the starting prices are fairly established. It may perhaps be presumed that the possibility of a reduced price (75%) to the mortgagee after a second failed auction will induce most mortgagors to sell the property to the mortgagee for the first starting price if the first auction fails. However, it is possible that in many instances mortgagors will not be inclined to cooperate and will demand a second auction. Moreover, even if the mortgagor does cooperate to transfer the property to the mortgagee after a first failed auction, by requiring a separate negotiation and agreement between the mortgagor and mortgagee the present law may delay execution. Finally, participation in the bidding is one of the few efficient ways that the mortgagee has to assure that the property is sold at a price which protects his interests. For all of these reasons, it is recommended that mortgagees be permitted to bid at initial auction sales, if not in all cases at least in the case of non-residential property, and to credit their loan amount against the amount of their bid.

#### **10. ONE BIDDER RULE**

The Mortgage Law invalidates any auction sale at which there is only one bidder. This is also a rule of the Civil Code with respect to auctions in execution of judgment. However, as noted earlier, the rule of the Civil Code could be superseded if in the Mortgage Law single-bidder sales were permitted.

Again, experience of other countries shows that inducing even one bidder other than the mortgagee is difficult, let alone two. Moreover, because the auction process is based upon a starting price set by the parties or the court, the possibility of extremely low and unfair bids, which would not only erase the borrower's equity but also place him at risk of deficiency judgment, is not great, if possible at all.

As discussed in the prior section 9, the implications for the mortgagee of a failed first auction may be slight as the mortgagee may be able to negotiate acquisition of the property with the mortgagor. Nevertheless, the first choice of mortgagees is generally to be paid the loan amount, and not to have to acquire the property and sell it. Since allowing auctions to proceed with one qualified bidder who meets the starting price would relieve the mortgagee

of the burden of acquiring the property, it is recommended that the mortgage auction sale be permitted to go forward with only one bidder so long as the starting price is met.

## 11. DEFICIENCY JUDGMENTS

Early drafts the Mortgage Law specifically provided for deficiency judgments against the borrower in the event that the foreclosure sale proceeds were inadequate to compensate the mortgagee. The most recent version of the law now before the State Duma appears to have deleted this provision, but it remains in the Civil Code and likely would be available to mortgagees as it is not specifically rejected by the Mortgage Law.

The issue of deficiency judgments is ambiguous in the following respects, however:

- The law allows the mortgagee to negotiate transfer of ownership of the property in lieu of foreclosure, and to reach a settlement agreement with the borrower to have what amounts to a private auction sale. It is not clear, however, whether a deficiency judgment will apply in either of these cases. Presumably, negotiated acquisition of the property by the mortgagee will rule out any possibility of a deficiency judgment, if not by law, then by borrowers who will soon learn to make this a condition of negotiated agreement. In the private sale transaction, the result is not clear, and the point is relevant because the starting price in such private auctions may be set without court supervision. However, it appears now that under the provisions of the Civil Code the mortgagee will be entitled to a deficiency judgement unless otherwise provided in the mortgage contract.
- The law allows the mortgagee to take the property for 75% of the starting price after two failed public auction attempts. Presumably, again, the starting price will be set to avoid deficiency judgments against the borrower, but there is no guarantee this will be done. For example, the law does not require that the initial starting price be set at least at the amount of the debt and costs. Consequently, it is possible that in such cases the mortgagee might come up short, and the question of a deficiency judgment ambiguous. The question is: if the mortgagee can acquire the property for only 75% of the starting price, is it entitled to a deficiency judgment against the mortgagor if that amount is less than the amount of the debt?<sup>9</sup>

A typical approach to mortgagee participation in the auction process is to allow the mortgagee to bid whatever it thinks the property is worth, credit its outstanding loan amount to that extent, and then seek a deficiency judgment against the borrower. This simple model

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<sup>9</sup> Depending upon the starting price, the mortgagee can be required to pay more for the property than it is worth. If the price is set unrealistically high - above the true market price of the property, the mortgagee may actually be required to pay cash in addition to crediting the balance of his loan. This strong protection for the borrower as he can be protected against having his equity wiped out by a bids which may amount to only a fraction of the market value of the property. On the other hand, if the starting price is unrealistically high, the mortgagee may end up with a property worth less than the debt and unable to obtain a deficiency judgment against the borrower.

clearly favors the mortgagee, and in fact has been modified by legislation in many places that limit deficiency judgments to the actual value of the property regardless of the amount for which it is acquired at public sale. The approach of the Russian law favors the borrower by setting starting prices and minimum final bids by mortgagees (75% of starting price). While this approach may not favor mortgagees, it is difficult to say that it is wrong as a matter of policy in light of its prevalence in other advanced legal systems.<sup>10</sup>

Nevertheless, the ambiguities regarding deficiency judgment could be cleared up. It is recommended that the law be modified to include the following:

- Clearly identify the cases in which a deficiency judgment is permitted. Typically, deficiency judgment is permitted where the auction sale does not produce enough to compensate the mortgagee, but not permitted where the mortgagee negotiates an acquisition of ownership of the mortgaged property. In the cases of private sales which are not under the supervision of the court, deficiency judgments are typically permitted based upon the appraised value of the property, and not the amount actually received at the auction sale.
- Alternatively, the law could provide that all deficiency judgments would be based on the appraised value of the mortgaged property, as determined by the court, regardless of the amount received at the auction sale.
- Clarify the significance of the mortgagee's right to take the property for 75% of the starting price; is the mortgagee entitled to a deficiency judgment of that amount if less than the amount of the debt?

## **12. RIGHTS OF OVERLYING MORTGAGEES**

The Mortgage Law allows overlying mortgages and describes them in considerable detail. However, the law creates several ambiguities which may tend to discourage the use of such mortgages:

- The law states that foreclosure of a senior (underlying) mortgage cuts off the rights of junior (overlying) mortgagees. This is a typical approach in most systems. However, the law seems to allow this termination of the junior interest even if the mortgage is enforced through negotiated acquisition of the mortgaged property by the lender or through private sale. In those cases there is little protection for the overlying mortgagees, particularly in the case of negotiated acquisition.
- In prohibiting mortgagees to participate in bidding in auction sales, the law does not make exception for overlying mortgagees. Participation in bidding on foreclosure of an underlying mortgage is a good way for overlying mortgagees to protect themselves.

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<sup>10</sup> The approach taken here can be compared to the many techniques to limit deficiency judgment among the American states, ranging from outright prohibition of deficiency judgments in residential loan transactions to requiring that deficiency judgments be based on appraised value and not bid proceeds. In fact, the likely effect of this type of provision may not be to discourage all mortgage lending, but simply to encourage better loan underwriting procedures.

- While mortgagors are given the right of redemption at any time up to completion of foreclosure sale, overlying mortgagees are not specifically given this right. (However, the general provisions of the Civil code may perhaps treat the overlying mortgagee in such cases as a creditor of the mortgagor entitled to redeem the property and be subrogated to the rights of the underlying mortgagor. Further investigation of this possibility may be required.)

To address these issues it is recommended that three modifications be made to the law:

- Provide for survival of the overlying mortgages in all circumstance other than judicial foreclosure proceedings or non-judicial proceedings in which the overlying mortgagee is given notice and the right to participate.
- Permit overlying mortgagees to bid at foreclosure sales of underlying mortgagees but provide that they may not credit their outstanding loan balance against the auction purchase price.
- Allow overlying mortgagees to protect their interests at any time prior to the foreclosure sale by purchasing the underlying mortgagee's right to claim against the mortgagor for an amount equal to the debt owed to the underlying mortgagee. Rights to purchase the right to claim against the mortgagor would be determined by strict order of priority and the purchasing overlying mortgagee would be subrogated to the rights of the underlying mortgagee against the borrower.

### 13. ACCELERATION

Enforcement of mortgage security is generally impractical without the possibility of accelerating the obligation for the entire amount of the mortgage loan. The law permits acceleration if the borrower fails to maintain and protect the property and property rights, or if he violates prohibitions against transfer or further pledge. The law allows foreclosure for financial defaults, including persistent late payment, but does not specifically allow acceleration of the loan. This perhaps unintended distinction may cause some interpretive problems. It is recommended that the law be modified to specifically allow acceleration of loans for financial defaults.

### 14. TIME FOR PAYMENT OF BIDS

The law allows for payment of bid prices within five days of the close of an auction. This may be too short a period of time, particularly for large and costly commercial projects. It is recommended that the time for payment be extended, perhaps to ten or fifteen days.

### 15. DISTRIBUTION OF PROCEEDS

The law gives priority to the mortgagee in the distribution of proceeds of foreclosure sale except as provided in the laws of the Russian Federation. At this time the Code of Civil Procedure of the Russian Federation already gives priority to several other claimants, including unpaid wages and salaries and obligations arising from injury to persons. This list can be expanded, possibly with retroactive effect on mortgagees. These priorities, given to mostly unregistered interests, and the possibility of future priorities applied retroactively, undermine the essential purpose of mortgage finance. The priorities given to unpaid alimony, wages and compensation for personal injury are longstanding elements of Russian law, and are in fact found in other types of forced sale or liquidation procedures, including the bankruptcy laws; they have deep social and political roots. Nevertheless, it is recommended that the law provide that only claims and interests registered prior to the mortgage have priority over the mortgagee, with the exception of claims for taxes and other public charges, and that any future expansion of the list of priority claims will not be applied retroactively to existing mortgages.

#### **16. RECORD KEEPING**

The law appears to provide that records of partial payments on mortgage loans will be made by notation directly on the mortgage documents. This is true at least with respect to the "zakladnaya," a transferable instrument which is derivative of the mortgage and which facilitates secondary transactions in mortgage credits. However, there is some ambiguity whether such direct annotations will be required with respect to all mortgages.

Direct notations on debt instruments and mortgages is not tailored to the needs of modern lending. Not only does it require that original documents be kept on hand at bank locations, but that they be handled frequently to make notations, increasing the possibility of transcription error. The additional costs and risks imposed would not be acceptable to most foreign lenders.

Rather than requiring direct notations of payment on mortgage documents, it is recommended that legal presumptions be established which achieve the same purpose as follows:

- Mortgagees are obligated to provide mortgagors not less frequently than quarterly with a statement of the account. If a statement is not provided, there is a legal presumption that the borrower is current on his obligations.
- A person acquiring rights to an existing mortgage enjoy the legal presumption that the mortgage debt is paid currently, unless otherwise disclosed by the transferor. Any failure of the transferor to disclose delinquencies makes the transferor liable for any losses incurred by the transferee.

#### **17. DEFINITION AND USE OF ZAKLADNAYA**

The mortgage Law seeks to reestablish the “zakladnaya,” a pre-revolutionary form of real estate mortgage instrument which shares some of the characteristics of a mortgage and a negotiable financial instrument. As described in the Mortgage Law the zakladnaya would be a registered instrument which is issued by the local registry on the basis of a registered mortgage - that is, it is not itself either a credit agreement or a mortgage, but rather evidence of the existence of a credit agreement and mortgage which may perhaps be compared to a mortgage-backed security. The zakladnaya would on its face recite the fundamentals of the registered mortgage and be registered in a separate registry maintained by the real estate registry apart from the real estate records.

The apparent intention of the zakladnaya is to circumvent the provisions of the Russian Federation Civil Code which may require that transfer of a mortgage requires notarization and registration of an instrument of assignment, both of which presently add significant costs to a mortgage transaction.<sup>11</sup> Moreover, there is some indication that the zakladnaya instrument provides some “holder in due course” benefits to an assignee - that is, the bona fide purchaser of the zakladnaya is not subject to many defenses that the maker of the zakladnaya might raise against the original holder of the instrument. In both cases, the zakladnaya is specifically designed to facilitate secondary market transactions in mortgage debt.

The zakladnaya is a complex concept and it remains to be seen how or whether it will be acceptable in the marketplace. It might be argued that the main issue which it addresses - the costs of notarization and registration upon transfer of a mortgage, and the issues surrounding protection of bona fide purchasers of financial instruments - might have been better dealt with by reducing notary and registration fees and by enacting a general law on negotiable financial instruments, rather than creating a hybrid mortgage instrument. In addition, there are certain characteristics of the proposed instrument that may tend to defeat its essential purpose, including:

- apparently, it is registered security and all transfers also must be registered;
- any number of attachments may be attached, which distinguishes it from the simple, legally elegant concept of “negotiable instrument” found in other legal systems;
- apparently, the zakladnaya must physically reflect payments by notations on the instrument itself or on attached schedules.

It is not clear at this time whether the zakladnaya will add much value to the mortgage system. It is unlikely that it will be relevant to large commercial mortgages, as they are not frequently transferred. The requirements of registration and physical notation of

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<sup>11</sup> It is not clear that under Russian laws it is even necessary to formally assign or register a mortgage document if the underlying debt instrument - which does not need to be notarized or registered - is assigned. Under the principles of many legal systems, apparently including the Russian Civil Code, the beneficial rights to mortgage security follow the ownership of the debt, regardless of whether an assignment of the mortgage security has been made. There are strong arguments that this principle applies under the Russian Civil Code, but it has not been widely endorsed by the Russian legal community.

payments on the instrument itself make them virtually useless for the secondary market in home mortgage loans, should one develop. It is also likely that their utility may diminish as a more realistic approach is taken to notarization and registration fees for such things as assignments of security rights (at present the notarization and registration fees would be charged as if the assignment were a new obligation) and as the general laws of transferable financial instruments develop.

## LOCAL ISSUES

Mortgage law is a matter of federal legislation. There are nevertheless some important areas in which local law can make a significant difference in the legal environment for mortgage lending. Such issues include the following:

### 1. PRIVATIZATION

Russia is in the process of creating private rights to real estate for the first time in over 70 years. The process consists mainly in the transfer of state ownership to private ownership or some other form of tenure, frequently leasehold. This is the process of "privatization," and it can be viewed as creation of the first link in the "chain of title" to property that will stretch into the future. If the first link is defective, problems may arise. For example, apparently there are occurring now in Moscow numerous challenges to initial privatizations of apartments, frequently alleging that the statutory process of privatization was not correctly followed. In some cases family members challenge the rights of other family members on the grounds that they were not present when privatization occurred and were not properly notified of the privatization. Apparently, some title have been quashed on these grounds.

Some of the banks participating in the commercial loan project complain that the process and documentation related to privatization of real estate are not clearly defined and that the often documentation is incomplete or improperly prepared. They allege that the process and the documentation are unreliable, requiring time consuming investigation of the entire process of initial privatization. In contrast, some other banks believe that the procedure and documentation of real estate privatization is well defined and do not see this as a major issue. In fact, the difference of opinion may depend on the locality.

The procedures and documentation of privatization appear to be reasonably well defined in federal law and regulation, at least to the extent that local administrations can devise a workable program. Problems may arise, however, in local practice. Much may depend upon whether the local administration has implemented a careful, well defined privatization process. If banks are to have confidence in the title of their loan applicants, the local administrations could perhaps consider the following program of action:

- Clearly define the process of privatization based on federal law and any additional local requirements. A clear and unvarying checklist of procedures would provide to lenders a means of certifying the validity of the transaction. The defined procedure

would also identify those persons authorized to certify title on official title documents by seal and signature.

- Enforce the procedural steps with diligence. In the act of creating initial titles, it is shortsighted to take shortcuts if it will only lead to ambiguous titles or threat of litigation at some future time.
- Keep comprehensive minutes and records of the process which can be relied upon by banks in the initial title examination and used to prove title in case of later challenges.
- Promulgate one, or a limited set of, definitive title documents.

This program could perhaps be enhanced by a federal law which would:

- Establish a legal presumption that a privatized title duly issued and documented is valid, placing the burden on challengers to prove otherwise.
- Set a short statute of limitations - perhaps 90 days - on challenges by parties who had proper notice of the privatization transaction.
- Define a limited set of defects in the privatization process which can be alleged by challengers and considered by the courts.
- Establish that technical defects in otherwise validly issued documents may not serve as the basis of challenges to initial privatization transactions.
- Apply a general rule of estoppel to local administrations, preventing them from later challenging transactions for which they were responsible except in exceptional cases of fraud on the part of recipients.

In the shorter run, those who privatize real estate should be made aware that they are not helping themselves by seeking shortcuts and not insisting on a painstaking process both with their own attorneys and with city officials.

## **2. LEASEHOLD MORTGAGES**

Increasingly, existing buildings and structures are held in ownership and mortgaged as property. However, leasing is still the predominant form of tenure in most cities. This is particularly true with respect to new construction projects, in which the land on which the project is developed is leased for a term of 49 years, but many existing buildings are also subject to leaseholds granted by the city.

There appears to be no legal barrier to pledging lease rights. The Civil Code allows pledge of property rights as well as property, and specifically provides that a pledge of lease rights requires the consent of the lessor. The Mortgage Law will provide that a pledge of lease rights to real estate will be subject to the provisions of the Mortgage Law. The Law On

Registration of Rights to Real Estate specifically requires registration of leases of real estate, thereby allowing registration of a mortgage on the lease.

Nevertheless, banks seem reluctant to take a pledge of lease rights. The crux of the issue seems to be that pledge of a lease right requires the consent of the owner of the property, which in most cases is still the municipality, and municipalities seem to be unwilling to grant such consent. In fact, mortgaging of lease rights is often specifically prohibited in city lease documents. While it is possible to obtain city consent to mortgaging lease rights, developers are wary of entering into transactions in which they would be dependent upon city discretion for such a potentially important right.

The rationale for prohibiting mortgage of leasehold rights is unclear, other than the possibility that cities may feel entitled to control completely the process of allocating their land, and the possibility of foreclosure of a mortgage by a mortgagee chosen by a lessee would seem to thwart that level of control. In light of this, leasing clearly is a poor substitute for privatization of ownership, and dampens the possibility of creating a real market based upon leasehold interests. The policy of restricting rights to mortgage is also shortsighted, as it must be presumed that the reason the cities privatize at all is to encourage private development, and restricting the right to find financing will not achieve this. Moreover, the threat to the city by allowing legitimate lenders to take liens on leaseholds seems to be inconsiderable, as the lender's incentives are all in favor of seeing projects completed also.

A better approach by the cities would be not only to permit mortgaging without city interference, but to also do everything possible to convince the banking community that it respects the rights of mortgagees. One way to do this would be to prepare and publicize a policy statement on the mortgaging of city leases. At a minimum, such a policy would include the usual protections required by leasehold mortgage lenders throughout the world, such as:

- Assurances from the lessor that it will not interfere with foreclosure of the mortgagor's rights, or with an assignment of the lease rights to the mortgagee or any other person who acquires at a foreclosure sale.
- Assurances that the lease will not be terminated without notice to the mortgagee and giving the mortgagee a reasonable period to cure any default of the lessee.

In addition, it would be helpful if cities would make a firm policy of assuring prompt consideration of requested agreements from mortgagees, and take all necessary steps to prevent bureaucratic attempts to make the process a source of personal profit.

### 3. LAND MORTGAGES

On construction projects, many cities are not granting lease or other long term land rights prior to completion of construction. In most cases the rights that are granted are short term rights of use or construction, and these rights generally may not be registered as interests in real estate. Coupled with the fact that under present law an incomplete structure could not be registered a real estate, lenders were left with no real estate interest on which to register a mortgage.

As noted, the issue of registration of incomplete structures as real estate is addressed in both the Law On Registration of Rights to Real Estate and the Mortgage Law. However, the issue of taking a mortgage on land rights remains open to some extent. The Civil Code provides, and the Mortgage Law will provide, that a mortgage cannot be taken on a structure without a mortgage also on the right of ownership or lease to the land underlying the structure. With respect to rights of use, an antiquated land right still much in evidence in Russian municipalities, the law provides that any successor to the present right holder, including a mortgagee, will obtain the same rights of use as the present holder. The underlying issue of the extremely tenuous value of a right of use, particularly with respect to commercial projects, is not addressed.

Localities can further support mortgage lending by implementing the following:

- Accelerating conversion of rights of use to clearly defined land rights, such as ownership or lease for a term of years.
- Grant rights of ownership or lease prior to commencement of construction of a project, at which time mortgage lending is most appropriate. Alternatively, grant rights of long term lease during construction which is convertible to ownership upon completion. The point is that it is unlikely that a “right to construct” or “right to invest” as presently used in some Russian municipalities will ever be a mortgageable property right.

## **REGISTRATION OF MORTGAGES**

### **1. LAW ON REGISTRATION**

Under the 1994 Civil Code of the Russian Federation rights to immovable property, including mortgage rights, must be registered with the “unified state agency” for registration of rights to immovable property. The Civil Code anticipated that a separate law of registration of rights would be enacted to define further the system of registration. The Russian Federation Law On State Registration of Rights to Real Property and Transactions With It (the “Registration Law”) was adopted by the State Duma on its third reading on July 19, 1996, and at the date of this report awaited transmission to the Federal Council and, ultimately, to the President for signature. The following analysis assumes that the law is enacted in its present form, though after years of controversy and intense bureaucratic conflicts within the Russian Government, it may be rejected by either the Federal Council or the President.

The Registration Law requires registration of any transaction which originates, transfers, encumbers or terminates rights to real property, including, specifically, mortgage transactions. Other rights which must be registered and which are pertinent to mortgage lending include leases, servitudes/easements, attachments, judgments, use limitations,

adverse claims and trust agreements. Failure to register nullifies the legal effect of the right, which in effect means that it can establish no priority over competing claims.

Registration is to be made in local registries which are under the supervision of the Ministry of Justice with respect to normatives and methodology, but which are organized as administrative units by decisions of the subjects of the Federation. The registries are to be independent public entities limited to the task of registration of real property rights and interests. The registries are to have responsibility for registration of rights to all forms of real property - that is, all land and structures, regardless of use or ownership - which is a substantial improvement over the system of multiple registries now existing in Russia.

Responsibility for the geodetic component of registration - including delineating land boundaries for registration and preparation of maps and cadastres - is to be defined by additional federal law. Such work may fall to the Federal Land Committee (Roskomzem) and its local affiliates, which is presently delegated responsibility for cadastral work.

Mortgages are to be registered in the district in which the mortgaged property is located. Registration fees will be established. Each defined object of real property - which may be a land lot, building or portion of a building recognized as a distinct object of real property - will have a registration case containing the essential physical and juridical data on the property. Registration cases will be kept by the cadaster numbers of the defined real property objects. Mortgages will be registered in section 3 of each registration case, along with other encumbrances on the rights of ownership, or other possessory right, to the property.

Registration of mortgages will be made upon application of the mortgagor accompanied by a notarized original of the mortgage agreement. Registration can be refused if the submitted documents do not meet the requirements of the civil legislation, or if there is a question raised about the property rights of the mortgagor. Termination of registered mortgages may be registered only by application of both the mortgagor and mortgagee, or upon court order.

A registration transaction may take as long as 30 days, but the effective date of registration will relate back to the date on which the application is received. The registry must issue a dated receipt for applications and date stamp applications and documents received for registration.

Registration records will be open to the public. However, while a copy of the mortgage agreement is to be retained in the registry files, there will be no general access to the documents. The registrar is obliged to issue, for a fee, a title report in a form to be specified by the Ministry of Justice. Upon issuance, a title report is guaranteed for a period of 10 days, and during that 10 day period the registry may not accept any further applications affecting the property for that ten day period.

The pending Mortgage Law, discussed above, also includes provisions for registration of mortgages. Those provisions seem to track closely the requirements of the Registration Law and establish no apparent conflicts. However, if conflicts between the two laws are deemed to exist there is no indication as to how they should be resolved.

## 2. REGISTRATION ISSUES

As a general matter, the Registration Law raises the following issues from the perspective of the mortgage lender:

*Unregistered Rights and Priorities.* The Registration Law requires registration of the following real property interests:

- ownership and other material rights (usufruct, life estates, economic management, etc.)
- mortgages
- servitudes
- leases
- judgments
- attachments
- trust agreements
- public and private land use limitations (restrictive covenants)
- applications on right of claim

The general rule of the Civil Code is that failure to register an interest in immovable property which must be registered renders the interest null and void. Since the law permits registration of an interest at any time, the rule of the Civil Code should probably be interpreted to nullify the unregistered interest vis-a-vis a conflicting interest which has been registered - that is, this is a rule of priority among conflicting interests. Accordingly, there is some foundation for the argument that any of the above interests which are not registered prior to registration of a mortgage will be subordinate to the rights of the mortgagee.

There are certain ambiguities, as there are in any system. For example, there may be a conflict between the laws of civil procedure and the registration law regarding the priority of judgment liens. The present laws make no specific allowances for protection of prior registered interests in the event of enforcement of judgment liens by execution sale, but, at the same time, there is no reason to believe that a mortgagee will not be protected. Many examples can be shown where there is no explicit guidance in the law, and the resolution of conflicts will have to be based on a wide reading of the Russian laws and court interpretation. This is perhaps to be expected in a new system which contains many legal concepts which have been lost to the Russian law over the past 70 years. It may be simply a matter of time before authoritative interpretation arises which will clarify most ambiguities of the law.

More significant perhaps is that the Civil Code and Mortgage Law both provide the mortgagee with priority over all other creditors of the mortgagor "with the exceptions provided by the laws of the Russian Federation." Consequently, at best it is possible to say that, upon enactment of the Registration Law, the priority of the registered mortgagee will be subject to any exceptions which may be found in existing or future laws. While the contents of future laws clearly are not known now, there are probably few people who can identify all of the potential conflicts with presently existing laws as well.

The laws of civil procedure have always given priority to execution sale proceeds to various parties, including, for example, employees who are owed wages, outstanding family support, outstanding judgments for injury to persons or damage to property, unpaid taxes and social insurance contributions. While these are known priorities, none of which must be registered, the code of civil procedure under which they are established dates from long before the present crop of laws and the continuing validity of these priorities is an open question. For example, the Registration Law requires that court judgments be registered, while the code of civil procedure seems to give an automatic priority to such judgments regardless of registration or even when they arise.

It may take years to identify and resolve the potential conflicts in the laws. However, to accelerate the process consideration might be given to the following:

- Under the Registration Law the Ministry of Justice will be responsible for giving legal and methodological guidance to the registration system. In preparing its normative directions for the registries, the Ministry of Justice should conduct a comprehensive review of the existing laws to determine the potential conflicts with the registration law in terms of priorities given to unregistered interests. Such a review would determine whether such existing priorities continue despite enactment of the new registration law or are subordinated to the requirements of the registration law. The Ministry might advance resolution of any perceived conflicts by offering its opinions on the correct interpretation of the laws.
- Modify the law to provide simply and clearly that (1) any unregistered interest which is required to be registered may not be given priority over the interests of any registered interest, (2) interests which do not have to be registered may be given priority over registered interests only if specifically identified in the laws, and (3) no law may establish priorities over registered interests retroactively.

*Claims Against Registered Titles.* A variation of the issue of unregistered rights is the question of what claims or challenges will be permitted against registered titles. This is essentially the question of what protections the registry provides to persons who rely on it in good faith. The Russian Registration Law is a law of "registration of rights," as understood in the European sense, in name only. In fact, it provides only for registration of documents much in the way of the American system, and establishes few guarantees of title to persons relying on the registration system for information.

The system establishes a few basic principles, such as prior registered rights have priority over later registered rights, and all persons are legally deemed to be on notice of the contents of the registry. Beyond this, the registration law sets out a number of claims which may be made against any registered right, and which may potentially undermine the rights of the mortgagee. These claims are written so broadly as to potentially include any hostile claim. They include:

- Fraud in which the right holder or the registrar participated or had knowledge. While the participation in or knowledge of the fraud by the registered holder of a right will generally defeat title in most systems, the participation of the registrar is a new

wrinkle that could cause serious problems. It is conceivable that if the registrar fraudulently registered an ownership right in collusion with someone else, the title of a bona fide purchaser without knowledge could be defeated simply because of the act of a prior registrar.

- An allegation that the transaction was invalid from the inception as a matter of Russian law.
- An illegal or invalid privatization transaction.
- Any other claim recognized under the laws of the Russian Federation.

Most of these grounds for challenge are based on information which cannot be contained in the Registry. Consequently, there is little if any protection for the bona fide purchaser who relies solely on the record. In effect, the upshot of this approach to registration is that most lenders will want to obtain title insurance. While this may not be a disincentive to American lenders, the fact is that title insurance is not widely available in Russia, and not available at all on large loans.

Over the long run it is possible to recommend that the Russian law try to move closer to what it initially set out to be - which is a European style system of guaranteed registration of rights. However, this system was considered and apparently rejected by the Russian Government because of its budgetary implications. It is likely, therefore, that the Russian system will develop as the American, and that few transactions will be written until there is developed some reliable system of registration and title insurance, which could be years in the future.

*Title History.* Another related issue is the scope of investigation which a user of the registry must undertake. In defining the claims that may be made against registered titles the law places no limitation on the time at which the events which form the basis of the claim arise. For example, a defect in title based upon a claim that some underlying transaction was void as a matter of Russian law could be the basis of challenging a registered title, no matter when it occurred. So, if, for example a title was transferred by a minor 50 years ago, that transfer could be used to unravel the entire succeeding chain of title. This places the burden on the user of the system to familiarize himself with the entire history of the property and rights to it, as in many American states, without limitation. To correct this problem, it may be possible to amend the law to provide that facts or events occurring more than a defined number of years prior to a claim cannot be used as the basis for a challenge to a registered title. This would at least serve to limit the scope of investigation of the title history of the property, and in fact is the approach taken in some American states in their title acts.

In effect, the entire issue of what facts the user of the registration system is held to have notice of, and which may effect his title, is left largely undefined. For example, it is not yet known whether the official title report to be issued by the registry is to include the entire title history of the property, or only presently effective rights, and if only the latter, whether a bona fide purchaser can be affected by defects in earlier titles. Similarly, the law suggests that the users of the system will not have access to original documents archived in the

system. Is the purchaser nevertheless on notice of any title defects which may be revealed by the documentation, and obligated to seek copies of the documentation elsewhere?

### **3. LOCAL EFFORTS**

Registration of mortgages at the local level has not been a major issue to date because there are so few mortgages to register. As a legal matter, the law provides that mortgages are to be registered and where - real estate mortgages are to be registered in the place where the real estate is registered. Under the current Russian system this means that a mortgage on land will be registered in the land records maintained by the land committees, a mortgage on an apartment will be registered in the housing registry; etc.

With respect to land, there is a well defined approach used by the land committees which was issued by Roskomzem several years ago and which remains in use today. Forms for registration of mortgages are provided, which define the information which is to be included in the registry. On other types of real estate the issue is more ambiguous, and at an administrative level registration of mortgages may depend upon how much effort has been put into registration by the local administration. Cities with well developed local systems of registration of housing interests, for example, such as St. Petersburg, also have well developed procedures for registering mortgages on housing.

Enactment of the Registration Law, and creation of the unified state registration agencies, will bring some uniformity to this process, as all real estate, and consequently all real estate mortgages, will be registered in the same place. It is likely that new instructions or formats, perhaps including a standard form of mortgage document, may eventually be proposed, but it is at this time too soon to know what these instructions may include.

The procedures and documentation for registering mortgages are not very complex and most of them are defined in the Registration and Mortgage Laws. While producing final instructions and regulations based on the new law might take some time, in the end more will probably depend upon how quickly and effectively the basic administrative mechanisms of registration are established in the cities. As noted, the law presently gives to subjects of the Federation the authority to set rules for creation of the administrative mechanism. This means, for example, that the subject may designate an existing agency - for example, the land committee or Bureau of Technical Inventory - to take on the responsibilities of the "unified state agency," or it may create an entirely new entity. Another possibility is that the subject of the Federation could delegate authority for creating the registries to local governments.

There will not be a great deal of extra budgetary support to create the registration agencies, and most places will have to rely on what they already have in place. Accordingly, it is essential that efficient use be made of existing resources and that a system be designed that can be implemented in local offices quickly and without expensive, complex electronic technology.

It will also be necessary for local administrations to assure the necessary cooperation among local agencies and departments if they want to see the registries established quickly and efficiently. Much of the task of creating the registration agencies will be the conversion and transfer of data from some existing agencies to others. In the past this has caused

significant problems and prevented progress on registration issues because local agencies which possessed data considered themselves to be “owners” and would not freely transfer the data to others. Unfortunately, the Registration law does not address the issue of ownership of existing data, and it may be expected that this problem will continue to be a barrier to creation of the registration agencies. A main task of the federal and subject governments in implementing the Registration law should be to establish rules for transfer of existing data among agencies, and how agencies are to be compensated for the existing data, both at initial data conversion and in the future if they continue to contribute data to the registration system. Failure to work out these economic issues will likely delay effective implementation of the system

### **SUMMARY OF RECOMMENDATIONS**

- The law should include a general principle that legal foreclosure results in termination of all third-party interests created without consent of the mortgagee after the effective date of the mortgage if the holders of the interests have had legal notice and the opportunity to participate in the proceeding. Limited exceptions could be made for taxes and other encumbrances of a public nature affecting the mortgaged property, and perhaps for court ordered servitudes. Although not specifically relevant to commercial property, the occupancy rights of minor children in residential property should be subordinated to the rights of their parents.
- The law should clarify which rights of third parties survive under the various forms of mortgage enforcement permitted in the law - judicially supervised auction sale, private auction sale, and negotiated acquisition. The strongest arguments can be made that only enforcement through sale procedures requiring notice to third-parties should result in termination of third-party interests, and that third-party interests survive negotiated acquisitions by mortgagees.
- Provide that upon negotiated acquisition of a mortgaged property by a mortgagee the mortgage is deemed to continue in effect until its maturity, or for some other specified period, thereby permitting the mortgagee to bring an action of foreclosure to terminate subordinate third-party rights.
- It is recommended that the usefulness of the non-judicial enforcement procedures of the law might be improved, particularly for commercial project lending, by considering the following:
  - Clarify that owners of leased property which is mortgaged by the lessee can consent to non-judicial enforcement at the time the mortgage is made.
  - Except from the definition of “enterprise” for purposes of the law any legal entity created solely to acquire, construct, own and operate a real estate project as an investment.

- Except from the limitation any project of historical or architectural significance on which restoration has been completed in accordance with an agreement with the owner. Such agreements generally provide for long term maintenance obligations which are binding on all subsequent owners of the property and should not be affected by a mortgage foreclosure. If the maintenance agreement is violated the municipal authorities have other remedies against the new owner.
  - Clarify that the limitation based on “common ownership” does not apply to non-residential investment projects and does not include shareholding or partnership in a legal entity.
  - Delete the present prohibition on negotiated acquisition of “land plots, structures, residential house or apartment.
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- With respect to the right of a court to delay execution of judgment for up to one year, the law might clarified by stating that the mortgagor is entitled only to pay the entire amount of the judgment, and not to reinstate the mortgage by bringing his payments current.
  - To minimize the risk of appeals of foreclosure judgments the following steps may be considered:
    - Prevent frivolous appeals by requiring the mortgagor or other claimant to file an appeals bond which guarantees to the mortgagee any losses of interest or other expenditures for loss of value of the property pending appeal;
    - Reduce the statute of limitations for appeals of foreclosure judgments from the present 3 years to 6 months;
    - Provide for an accelerated schedule for appeals of foreclosure judgments, giving priority to such appeals.
    - Provide that if a foreclosure sale is unwound the bona fide purchaser is entitled to reimbursement from the claimant in the amount of his principal, interest at a specific market rate, plus the costs of any capital improvements which he made to the property which cannot be removed.
    - Define the prima facie case for judgment on the debt in terms of the evidentiary and pleading obligations of the mortgagee and mortgagor. This will not only assist in quick resolution of actions at the trial level, but also expedite appeal by providing guidance to Russian courts of appeal that are presently authorized to consider all actions de novo.
  - With respect to identifying parties entitled to notice and right of appeal provide that:
    - Only parties having registered interests as shown in the registry of real estate, or whose interest arises by law, such as the beneficial rights of family

members to occupy residential property, are entitled to notification of the action.

- Notice to any other third-party will be deemed to have been given as a matter of law by publication in an official newspaper of a notice of the action to foreclose.
- Any claim not raised at the hearing by a party with notice can not serve as the basis for appeal of the judgment.
- Specifically allow appointment of a receiver and collection of rents pending completion of foreclosure proceedings on commercial, income producing properties, if necessary to protect the security of the mortgagee and minimize financial damages.
- Allow appointment of a receiver as a preliminary motion pending judgment on the foreclosure action.
- Specifically allow a pledge of leases, rents and other personal and movable property and equipment necessary for operation of the mortgaged property to be included in the mortgage document.
- With respect to modifications of underlying mortgages provide:
  - Term extensions do not require the consent of overlying mortgagees.
  - Changes to interest rates and principal balances of underlying mortgages are permitted if contemplated generally in the underlying mortgage - that is, the risk of modifications to the risk is placed on the overlying mortgagee if he is placed on notice of the possibility.
  - Permitted modifications to the terms of underlying mortgages may be made by amendment and the registration of the amendment does not affect the legal priority of the underlying mortgage if such modifications were permitted in the original mortgage document.
- Provide that lenders on loans disbursed in installments the right to continue to make protected advances to the full amount of the mortgage loan after an intervening lien arises, if such advances are for the purpose of completing a structure, paying interest on the loan, insurance premiums, rents or taxes, and maintaining the property.
- Provide that any property acquired by the state through confiscation for criminal or civil violations by subject to the rights of the mortgagee.
- Permit mortgagees to bid at initial auction sales, if not in all cases at least in the case of non-residential property, and to credit their loan amount against the amount of their bid.

- Permit mortgage auction sales to go forward with only one bidder so long as the starting price is met.
- With respect to the issue of deficiency judgments:
  - Clearly identify the cases in which a deficiency judgment is permitted.
  - Alternatively, the law could provide that all deficiency judgments would be based on the appraised value of the mortgaged property, as determined by the court, regardless of the amount received at the auction sale.
  - Clarify the significance of the mortgagee's right to take the property for 75% of the starting price; is the mortgagee entitled to a deficiency judgment of that amount is less than the amount of the debt?
- With respect to the rights of overlying mortgagees:
  - Provide for survival of the overlying mortgages in all circumstance other than judicial foreclosure proceedings or non-judicial proceedings in which the overlying mortgagee is given notice and the right to participate.
  - Permit overlying mortgagees to bid at foreclosure sales of underlying mortgagees but provide that they may not credit their outstanding loan balance against the auction purchase price.
  - Allow overlying mortgagees to protect their interests at any time prior to the foreclosure sale by purchasing the underlying mortgagee's right to claim against the mortgagor for an amount equal to the debt owed to the underlying mortgagee. Rights of redemption would be determined by strict order of priority and the redeeming overlying mortgage would be subrogated to the rights of the underlying mortgagee against the borrower.
- Specifically provide for acceleration of loans for financial defaults.
- Extend the time for payment of auction bids, perhaps to thirty days.
- Provide that only claims and interests registered prior to the mortgage have priority in the distribution of proceeds of auction sale, with the exception of claims for taxes and other public charges, and that any future expansion of the list of priority claims will not be applied retroactively to existing mortgages.
- Rather than requiring direct notations of payment on mortgage documents, it is recommended that legal presumptions be established which achieve the same purpose as follows:

- Mortgagees are obligated to provide mortgagors not less frequently than quarterly with a statement of the account. If a statement is not provided, there is a legal presumption that the borrower is current on his obligations.
- A person acquiring rights to an existing mortgage enjoy the legal presumption that the mortgage debt is paid currently, unless otherwise disclosed by the transferor. Any failure of the transferor to disclose delinquencies makes the transferor liable for any losses incurred by the transferee.
- Local administrations should consider the following program of action:
  - Clearly define the process of privatization based on federal law and any additional local requirements. A clear and unvarying checklist of procedures would provide to lenders a means of certifying the validity of the transaction. The defined procedure would also identify those persons authorized to certify title on official title documents by seal and signature.
  - Enforce the procedural steps with diligence. In the act of creating initial titles, it is shortsighted to take shortcuts if it will only lead to ambiguous titles or threat of litigation at some future time.
  - Keep comprehensive minutes and records of the process which can be relied upon by banks in the initial title examination and used to prove title in case of later challenges.
  - Promulgate one, or a limited set of, definitive title documents.
- Federal legislation should:
  - Establish a legal presumption that a privatized title duly issued and documented is valid, placing the burden on challengers to prove otherwise.
  - Set a short statute of limitations - perhaps 90 days - on challenges by parties who had proper notice of the privatization transaction.
  - Define a limited set of defects in the privatization process which can be alleged by challengers and considered by the courts.
  - Establish that technical defects in otherwise validly issued documents may not serve as the basis of challenges to initial privatization transactions.
  - Apply a general rule of estoppel to local administrations, preventing them from later challenging transactions for which they were responsible except in exceptional cases of fraud on the part of recipients.
- With respect to mortgaging city leases, local administrations should do everything possible to convince the banking community that it respects the rights of mortgagees.

One way to do this would be to prepare and publicize a policy statement on the mortgaging of city leases. At a minimum, such a policy would include the usual protections required by leasehold mortgage lenders throughout the world, such as:

- Assurances from the lessor that it will not interfere with foreclosure of the mortgagor's rights, or with an assignment of the lease rights to the mortgagee or any other person who acquires at a foreclosure sale.
- Assurances that the lease will not be terminated without notice to the mortgagee and giving the mortgagee a reasonable period to cure any default of the lessee.
- In addition, it would be helpful if cities would make a firm policy of assuring prompt consideration of requested agreements from mortgagees, and take all necessary steps to prevent bureaucratic attempts to make the process a source of personal profit.
- With respect to mortgaging of land rights, local administrations can further support mortgage lending by implementing the following:
  - Accelerating conversion of rights of use to clearly defined land rights, such as ownership or lease for a term of years.
  - Grant rights or ownership or lease prior to commencement of construction of a project, at which time mortgage lending is most appropriate. Alternatively, grant rights of long term lease during construction which is convertible to ownership upon completion.



*APPENDIX C*

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*Summary Report  
Activities with Baltiyskiy Bank, St. Petersburg  
as of August, 1996  
Development of a Commercial Real Estate Finance Market  
in the Russian Federation  
Contract No. EPE-0014-I-00-5070-00  
Barents Group, LLC*

**Director, Development Division, Serguei V. Ivanov  
Director, Finance Department, Elena V. Ugrumova**

The Barents team first met Baltiyskiy Bank, St. Petersburg in November 1995 during the diagnostic phase of the project. The Bank was not initially selected as a pilot bank for the project, but due to its continued involvement in the project by consistently sending participants to the training courses. Due to the Bank's continued interest in the program, their interest in the commercial real estate market and their experience with commercial real estate transactions, in June 1996, the Bank formally joined the Program.

The Team was assigned to work with the Finance Department, which was also responsible for working with the US-Russian Enterprise Fund. The employees that we worked with were well-prepared for all of the meetings and seminars, and were knowledgeable about banking and real estate law. They made a great effort to attend the classes, read and implement the materials within their Department's processes, and they utilized the available resources of the Barents' staff. Unfortunately, we found that the Finance Department had very limited experience with commercial real estate transactions, they had a few small business loans that were secured with real estate. Therefore, much of the information and training we were able to provide them with was only in preparation for their eventual involvement in an increasing number of such transactions.

In fact, there are two divisions within Baltiyskiy Bank involved in CRE lending: the Financing Department and the Corporate Department. The Corporate Department seems to handle larger clients and more complex transactions, which either are currently being or may be secured by commercial real estate in the near future. Employees of this division attended the CRE Workshop we taught at Baltiyskiy Bank. They found the course and the discussions with Barents' staff to be extremely useful. Further assistance to the Bank should also include this department.

Key activities and steps are noted below for the main areas of project focus:

- Institutional Infrastructure and Training,
- Legal and Regulatory Issues,
- Commercial Real Estate Transactions, and
- Intellectual Leadership.

### ***Institutional Infrastructure and Training***

The Barents team developed a Commercial Real Estate Credit Policy and Procedures Manual and for the employees of the Financing Department, Barents provided in-depth training of each chapter of the manual, describing prudent commercial real estate lending procedures from the application to the collection stage. Examples using American and Russian experiences were discussed.

Barents designed and developed three courses and delivered four in which the Bank's employees participated:

- Commercial Real Estate Lending
- Commercial Real Estate Lending Workshop
- Commercial Real Estate Appraisal
- Commercial Real Estate Lending Workshop, On - Site. Upon the request of the Bank, Barents' designed and ran this course separately for the Bank.

These course design took into consideration current Russian legal and economic conditions. Materials provided to the participants included those designed by the Barents team: the Course Manuals, Case Studies, Appraisal Manual, and the Loan Proposal Development Manual, accompanied with a cover letter from the Central Bank's Securities Department. The Team also provided participants with the book, "Income Property Appraisal and Analysis" by authors Friedman and Ordway and four manuals from the Society of Real Estate Appraisers: "A Guide to Appraising Industrial Property", "Shopping Center Appraisal and Analysis", "The Office Building -- From Concept to Investment Reality", and "Hotels and Motels -- A Guide to Market Analysis, Investment Analysis and Valuations".

The Barents team analyzed the Bank's computer application needs, and provided the following types of software models, designed by Barents and Excel based: 1) Discounted cash flow projection and net present value spread sheets, 2) Profit and Loss and Balance Sheet analysis, 3) Construction Budget and Requisition Forms. We also provided Commercial Real Estate Valuation Software Demonstration Package, designed by ARGUS Company.

### ***Legal and Regulatory Issues***

The Barents legal advisor met with the legal department of the Bank, which consisted of three lawyers who were responsible for all aspects of secured lending, from loan documentation to enforcement actions in court. The Barents legal advisor focused on the following questions:

1. What does the Bank perceive as the major problems in making loans on commercial real estate - land, lease rights, city approvals, enforcement?
2. What is the best way to secure loans today?
3. Have they enforced a loan in court and what are the problems?

In addition to the core questions, the main topics of discussion included mortgage enforcement procedures and alternative forms of security. The Bank had encouraging experiences with loan enforcement, arguing an important case to the RF Supreme Court, where they won a decision against a borrower. Their impression was that while the present procedures for loan enforcement - primarily, the advertised auction sale conducted by a court clerk - is somewhat cumbersome and inefficient, it could be made to work. Much would depend upon the quality of local judges and court officials, and this was expressed as a long term concern. Thus far in St. Petersburg they were satisfied with both.

A concern was expressed that the present law provides insufficient guidance for preparation of mortgage documents, and that the proposed law on mortgage would be a welcome addition to the somewhat skeletal provisions of the Civil Code.

The remainder of the discussion included alternative types of security devices to be used in commercial loan transactions, including: pledges of leases and rents (interesting but not used now: may be possible under existing law and worth exploring); appointments of receivers (not used at all presently; not likely to be permitted under present mortgage laws, but may be possible under general principles of secured lending); pledges of construction period documents such as permits, design and construction contracts (unheard of at present); and pledge of corporate control in single - purpose legal entities created for the purpose of constructing and operating a commercial building. On the basis of the discussion it was concluded that many of the security techniques taken for granted in international practice are not widely known in Russia and may in the short run be beyond the contemplation of the lending industry and the courts.

Barents provided the Bank with a chapter on the legal issues of Commercial Real Estate Lending, and numerous commercial real estate model bank documents that are structured to protect the Bank's interest in case of a dispute or default. The documents are tailored to the Russian market and reflect prudent clauses, for real estate lending that are consistent with the proposed legislation on Mortgage and Registration. The documents should protect the Bank because they reflect prudent clauses for real estate lending that are consistent with the proposed legislation on Mortgage and Registration.

### ***Commercial Real Estate Credit Transactions***

Because the Bank entered the program later than the rest, the transaction activities were accordingly fewer than our original pilot banks. The Bank was extremely interested in secured commercial real estate lending, however, due to the legal ramifications, they were not interested in construction finance. They did raise and ask questions regarding the following scenario which would circumvent the Bank's inability to foreclose on projects under construction - Financing construction by taking guarantees from a third party. If the direct construction borrower defaulted, the Bank would effect the guarantees, and the guarantor would take over the construction project.

The Barents Team assisted the Bank by discussing several existing Commercial Real Estate Transactions. Barents advised the Bank on general methods to appraise collateral, evaluate market studies, inspect construction jobs, and structure and restructure loans. General market analysis and information was also provided for retail space (luxury, mid and average types), office space (class A and B) and hotels (luxury and mid-class).

The Bank brought one major deal to the attention of the team, and indirectly requested Barents' assistance. The Bank learned from Barents' advice and implemented the suggestions and other information provided. The Bank did not mention the project by name, only intimated the project details, including type of project, location, amount of financing. This mixed - use project was developed by a major shareholder of Baltiyskiy Bank, and the Bank financed many of this shareholder's projects and businesses.

- *Transportation Corporation.* This corporation is developing a mixed use 35,000 square meter project, consisting of apartments, offices and garage. Barents provided advisory services on different restructuring techniques for the \$24,000,000 Phase I financing. Barents advised the Bank in implementing construction monitoring techniques, obtaining an independent market study and appraisal, and utilizing an independent engineer.

Coincidentally, Barents, prior to inviting Baltiyskiy Bank to join the program, was introduced to the transportation company and was requested to comment on the project and assist in the possible restructuring of project financing. Barents toured the project with the Project Manager, to observe first-hand the construction quality and progress.

The Team suggested the company try to pledge additional collateral including (office buildings, auto dealerships, cash payments from purchasers, lease payments of apartments, office and garage spaces, to repay the financing.) Security for the existing loan is the pledge of cash and shares of the company.

- *Owner-Occupied Transactions.* The Bank had two loans that were secured by real estate that had the potential of becoming problem loans, one to a clothing manufacturer and retailer, and one to a furniture store. Warning signs and methods of shoring up real estate credits were discussed, including monitoring the financial statements, hiring engineering and appraisal experts at the borrowers cost, and offsetting ruble accounts to pay interest and principal payments.

### ***Intellectual Leadership***

The Barents Team conducted research in the real estate market and presented a Pooled Equity Brochure to the Bank. Senior management was interested in the concept from an intellectual standpoint, and wanted to learn more about the processes of implementing an arrangement.

### ***Benefits of the Project/Recommendations for Further Assistance***

*Training.* The Senior Management understands the importance of training its employees. Initially, although not a formal member of the program, the Bank was an avid participant in the training courses offered through the Project. The assistance paralleled the Bank's work with the Russian-American Enterprise Fund Business Loan Program, which began to secure business loans with real estate.

The Bank has other departments and subsidiaries conducting commercial real estate transactions and secured real estate lending that we did not speak with in-depth. We recommend that these divisions be contacted, additional information obtained and included in the roll-out.

*Procedures.* The Bank needed methods to quantify the evaluation and monitoring of commercial real estate projects. By providing the software programs, the Financing Department that monitors large construction projects gained an introduction to the basics of commercial real estate lending. The Department was able to use the information for and increased their understanding of structuring commercial construction transactions, monitoring on-going construction jobs, and appraising commercial real estate projects. Further assistance is recommended in the area of appraisal, market and construction cost analysis and analysis of financial statements of large, complex borrowers.

*Policies.* The Financing Department required an upgrade to their existing Policy and Procedures to incorporate commercial real estate as security. By providing the Commercial Real Estate Policy and Procedures Manual, the Department benefited from methodologies gleaned from both the US and Russian experiences. The Financing Department was very familiar with their general bank policies and procedures, so the manual will be used to fine tune existing policies and procedures. Further assistance is recommended in incorporating CRE concepts to their existing manual if the Bank grows its volume of new CRE transactions.

**COMMERCIAL  
NOT FINANCIAL CONTRIBUTION**

***Summary Report  
Activities with Bank St. Petersburg  
as of August, 1996  
Development of a Commercial Real Estate Finance Market  
in the Russian Federation  
Contract No. EPE-0014-I-00-5070-00  
Barents Group, LLC***

**Director of Real Estate Investments- Vladimir S. Beznedelny  
Director of Credit Department - Vadim K. Kalinin**

The Barents team worked with Bank St. Petersburg's Real Estate Investment and Credit Departments over the course of the project. The employees were quite precocious and sophisticated in real estate, economics, and finance. The Bank was an active and cooperative participant of the program, made a great effort to attend the classes, read and implemented the materials within their Department's processes, and utilized the available resources of the Barent's Group.

After this close cooperation with the Barent's Group, the Bank was determined that commercial real estate was a viable, although risky business, and that the Bank must restructure its activities to move forward profitably in this field. The program was extremely beneficial and timely for the Bank, evidenced by the Bank's July 1996 formation of a working group of senior members of the Bank including the Real Estate Investment and Credit Departments. The group planned to use the Barent's Commercial Real Estate Policy and Procedures Manual as "the first brick in the foundation of the group's activities". These activities will begin to consolidate the commercial real estate activities within the Bank, to set clear policies and procedures for that Bank that will provide for prudent and profitable real estate endeavors.

Key activities and steps are noted below for the main areas of project focus:

- Institutional Infrastructure and Training,
- Legal and Regulatory Issues,
- Commercial Real Estate Transactions, and
- Intellectual Leadership.

***Institutional Infrastructure and Training***

The Bank required a complete upgrade of their internal infrastructure, as determined in the Needs Assessment phase of the project. This was based on their desire to capture a share of the growing CRE market in St. Petersburg. They had begun to invest in various segments of the CRE market and needed a well-developed infrastructure to carry out profitable and prudent CRE transactions.

The Barents team developed a Real Estate Credit Policy and Procedures Manual for Banks in the Russian Federation. For the employees of the Credit Department and Loan Operations, Barents provided in-depth training of each chapter of the manual, describing prudent commercial real estate lending procedures from the application to the collection stage. Examples using American and Russian experiences were discussed.

Barents designed and developed three courses, in which the Bank's employees participated, Commercial Real Estate Lending, Commercial Real Estate Lending Workshop, Commercial Real Estate Appraisal. These courses were designed to take into consideration current Russian legal and economic conditions. Materials provided to the participants included those designed by the Barents team: the Course Manuals, Case Studies, Appraisal Manual, and the Loan Proposal Development Manual, accompanied with a cover letter from the Central Bank's Securities Department. The Team also provided participants with the book, "Income Property Appraisal and Analysis" by authors Friedman and Ordway and four manuals from the Society of Real Estate Appraisers: "A Guide to Appraising Industrial Property", "Shopping Center Appraisal and Analysis", "The Office Building -- From Concept to Investment Reality", and "Hotels and Motels -- A Guide to Market Analysis, Investment Analysis and Valuations".

The Barents team analyzed the Bank's computer application needs, and provided the following types of software models, designed by Barents and Excel based: 1) Discounted cash flow projection and net present value spread sheets, 2) Profit and Loss and Balance Sheet analysis, 3) Construction Budget and Requisition Forms. We also provided Commercial Real Estate Valuation Software Demonstration Package, designed by ARGUS Company.

### ***Legal and Regulatory Issues***

The Barents legal advisor met with a lawyer of the Bank, responsible for all aspects of secured lending, from loan documentation to enforcement actions in court. The Barents legal advisor focused on the following questions:

1. What does the Bank perceive as the major problems in making loans on commercial real estate - land, lease rights, city approvals, enforcement?
2. What is the best way to secure loans today?
3. Have they enforced a loan in court and what are the problems?

As the Team tried to affect the necessary changes to the legislation facilitating CRE transactions, the Team discussed with the Bank's lawyer the current legal situation in Russia regarding CRE transactions, including the status of the land law, mortgage law, land and mortgage registration system, taxation of real estate, and suggested methods to improve this situation. The Bank's legal counsel offered the opinion that it was not presently possible to take a mortgage on lease rights, which eventually refined to mean that there is a lack of cooperation from the city to clarify rights of mortgagees with respect to city leases.

The main concern of the lawyer was the lack of proper laws and regulations to properly securing the Bank's rights under two scenarios: construction loan agreements and leasehold agreements. The reason for the concern under the construction loan scenario centered on a Bank's difficulty in foreclosing on collateral under construction in event of the Borrower's default. The second scenario was financing renovation projects under lease by the City. The City of St. Petersburg prohibited the mortgage or pledge of leasing rights on historic buildings that the City owned. Forty percent of the 5000 buildings in the city were classified as historic properties. These problems translate into the Bank investing in CRE rather than financing with debt.

Barents provided the Bank with a chapter on the legal issues of Commercial Real Estate Lending, and numerous commercial real estate model bank documents. These documents are tailored to the Russian market and are structured to protect the Bank's interest in case of a dispute or default. The documents should protect the Bank because they reflect prudent clauses for real estate lending that are consistent with the proposed legislation on Mortgage and Registration. The legal team also recommended changes to the law on mortgages, including adding specific items in the proposed legislation to support the Bank's rights and provide remedies under a Borrower's leasehold agreement.

### ***Commercial Real Estate Credit Transactions***

The Bank's general foray into the commercial real estate market was twofold: investments in construction projects, which were the primary focus of the Bank's venture into CRE, and business loans secured by real estate. The most notable investment was the Northern Crown Hotel, which is discussed under *Observations*. The business loans were targeted as multilateral funding projects under the auspices of the World Bank.

The Barents Team provided assistance to the Bank in analyzing several proposed Commercial Real Estate Transactions. Barents advised the Bank on the collateral appraisals and loan structures. General market analysis and information was also provided for retail space (luxury, mid and average types), office space (class A and B) and hotels (luxury and mid-class).

The Bank brought one major deal to the attention of the team, requesting their assistance, learning from their advice and implementing their suggestions and other information provided. Additionally, the Bank was open to reviewing Enterprise Land Sales transactions that Barents and a cooperating USAID contractor, ELS/PADCO, introduced to the Bank. At the close of the project, discussions were still underway with regard to potential financing for these transactions.

- *A Construction Company.* This company, a current customer of the Bank, is structuring a financing proposal for a \$4 million renovation and construction project. The original plans for this 4000 square meter mixed-use building were for apartments, office and garage. Barents advised that the company gather the proper data for market research, analyze and review the project, determine the highest and

best use of the property, and then reconfigure the plans accordingly. Advise for loan structuring centered on securing the loan with collateral of rights to build on the property, rights to lease the land and own the improvements upon completion, plus other collateral and guarantees during construction.

### *Enterprise Land Sales Transactions*

- *Tool Plant.* The Tool Plant requires \$250,000 to purchase a 3.8 hectare parcel of their land at \$6.50 per square meter, from the government. The Tool Plant wants to “flip” (resell) the land to a buyer that has signed a contract for \$1 million. The Tool Plant is experiencing a downturn in its operations. To mitigate credit risk, Barents suggested to structure the credit transaction with the land as collateral, plus the contract buyer depositing 25% of the purchase price in the Bank, as an (earnest money deposit) and collateral for a loan. The Bank has proposed this structure to the Tool Plant.
- *Aluminum Plant.* This Plant garners a majority of the Russian aluminum foil market. The Company generates a profit, has sufficient cash balances, and has purchased the land under its warehouses. It wants to purchase additional parcels, totaling 26 hectares @ \$1.15 per square meter or \$300,000. Suggested collateral for a loan includes existing warehouses and land. Bank St. Petersburg has agreed to review a loan proposal upon completion by the company.
- *Clothing Manufacturer.* This clothing manufacturer is fully privatized, with new equipment and foreign shareholders controlling 49% of charter capital. They want to acquire land under their factory, plus land within their complex and are willing to use their retail shops as part of the collateral for the loan. The source of repayment will be from the sale of raw land parcels within the plan complex. The company is in the process of developing a loan proposal and collateral appraisal for the bank to review.
- *Meat Processing Plant.* This privatized meat processing plant wants to acquire their land, 93 hectares, at \$1.15 per square meter or \$1 million. The company is willing to secure a loan with company shares, warehouses and retail shops. The source of repayment will be from the sale of raw land parcels within the plant complex. The company is in the process of developing a loan proposal and collateral appraisal for the bank to review.

### *Intellectual Leadership*

The Barents Team conducted research in the real estate market and presented a Pooled Equity Brochure and explained the concept in-depth to the Credit and Investment Department. The Bank was searching for other investors for Northern Crown Hotel project (see *Observations*) and Barent's discussed the pooled debt/equity approach to funding real estate projects. During the course of the program, the Bank located funding sources. However, these may fall through, and assistance could be provided to further the funding cause and to help restructure the project.

In general, the Senior management was interested in the concept, but felt that it would not yet work because of the legal and economic obstacles in the market now. Once these were overcome, the pooled equity and debt financing would be attractive for investors in the St. Petersburg market.

### ***General Observations***

According to some senior officials within the Bank, Bank St. Petersburg is experiencing a liquidity problem, as are many of the Banks in the Russian Federation. Two primary reasons contribute to the problem: economic factors and asset portfolio problems. Assuming one of these two problems is resolved in the foreseeable future, the Bank will be a major player in the St. Petersburg real estate market.

- 1) *Economic.* General economic conditions in Russia are straining liquidity for all banks. The Central Bank has planned to raise reserve requirements for all banks, squeezing banks further. With the threat of increased reserves, the inter-bank credit market for banks has tightened, in terms of decreased availability of credits, and increased rates.

St. Petersburg is slowly emerging from a depressed state, which directly affects the Bank. Customers are enterprises, many of which were military industrial giants, are now bankrupt and can not repay their loans. Transformation from a military and defense based economy to a market driven economy is painful and slow.

- 2) *Asset Portfolio.* The Bank's largest asset is the \$80 million investment project, the Northern Crown Hotel. The hotel was due to open in June of 1996, however, cost overruns occurred and funding stopped. The hotel is 85% complete and remains unopened. The main problem associated with this asset is the sheer size of the project, the amount of funds the Bank invested directly, and the fact that they should have diversified their risk, by spreading their investment resources over many different projects. The Senior Banker in charge of Real Estate Investments agreed with Barents' advice that the Bank should not be in the hotel business, and now there is a dispute among senior management as to whether to sell the property, or keep it in their portfolio of assets. Senior management reports that additional funding from outside sources has been obtained to complete the hotel. To date, there has been no evidence the funding was obtained.

### ***Benefits of the Project/Recommendations for Further Assistance***

*Transactions.* The Real Estate Investment Department's level of familiarity concerning the economics of the real estate market was apparent at the outset of the project. For the benefit of their clients in the real estate business, the Bank was interested in learning about commercial real estate lending. The assistance paralleled the Bank's involvement with the World Bank, as the Bank is an accredited FIDP bank (Financial Institutions Development Program of the World Bank) and credit quality is

a focus of the FIDP program. The Bank also agreed to be a participating bank in the World Bank Russian Federation Housing Program and Program to Transform the Credit Building Materials Industry.

Basic advice was provided for the Northern Crown Hotel, as mentioned above. The Bank was searching for other investors for the project, and Barent's discussed the pooled debt/equity approach to funding real estate projects. During the course of the program, the Bank located funding sources. However, if these fall through, assistance should be provided to further the funding cause and to help restructure the project.

*Procedures.* The Bank needed to introduce its lenders to the basics of commercial real estate lending to the Real Estate Investment Department. Provided with this information, the Bank was able to use the information for structuring commercial construction transactions, monitoring on-going construction jobs, and appraising commercial real estate projects. A large part of the consulting services included advising the bank on how to review commercial real estate loan proposals based on western standards, i.e., the types and amount of information, and the presentation methods. Further assistance is recommended in the areas of appraisal, market and construction cost analysis and analysis of financial statements of large, complex borrowers.

*Organization.* The Bank needed to organize its policies and procedures for CRE financing. The Commercial Real Estate Policy and Procedures Manual was used immediately. The Bank formed a working group of senior members of the Bank including the Real Estate Investment and Credit Departments. The group used the Barent's manual as "the first brick in the foundation of the group's activities". The activities began to consolidate the commercial real estate activities within the Bank, to set clear policies, and procedures for the bank that will provide for prudent and profitable real estate endeavors. It is recommended that during the roll-out phase of the program, the Bank should be provided with assistance in restructuring the organization and to build stronger divisions within the department.

The Bankers needed to quantify their evaluation and monitoring of CRE. With the software models provided, the Bankers learned the techniques of construction monitoring and valuation procedures for their commercial real estate investments, such as their largest, the Northern Crown Hotel. Further training may be necessary as the departments grow and the volume of CRE transactions increase.

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*Summary Report  
Activities with Eastern-Siberian Commercial Bank  
as of August, 1996  
Development of a Commercial Real Estate Finance Market  
in the Russian Federation  
Contract No. EPE-0014-I-00-5070-00  
Barents Group, LLC*

**Chairman - Ms. Tamara Tsarik**  
**Director of Mortgage Branch - Sergey V. Kurilov**

The Barents team worked directly with the Mortgage Branch of the bank, headed by Mr. Sergei Kurilov. The project received particularly strong support at ESCB as the Chairwoman of the Bank, Ms. Tsarik, was very interested in the project and met with the team on almost every visit. She understood the need for commercial real estate financing and worked with the team on issues relating to pooled equity and third party guarantees, including arranging meetings for the Team with senior Irkutsk City and Oblast officials.

ESCB was once a Promstroi Bank and underwent a change in management when converted to a private institution in 1992. It was evident that the predecessor bank had made some mistakes in real estate lending and the new management wanted to use this training to avoid similar mistakes in the future. Furthermore, the Bank's customer base includes companies likely to request commercial real estate loans in the future.

One of the Project's most significant achievement was working with the Bank to develop "pooled equity funds" for financing commercial real estate projects. During our first few visits to Irkutsk, it became apparent that investment funding for CRETs was limited. Working with the Bank, government officials and local investment companies, the team's Corporate Finance Specialist was able to persuade the parties that the pooled equity concept could work in Irkutsk and advised them of methods for setting up such a fund (see Intellectual Leadership and Government Participation sections). Pooled equity funding will allow more equity investment into real estate projects and result in less risky real estate loans for the Bank.

Our time with the Bank did produce transactions to review. We were able to review the appraisal and business plan for one real estate loan application for a commercial office project. We also reviewed the business plan for another loan request secured by real estate.

Key activities and steps are noted below for the main areas of project focus:

- Institutional Infrastructure and Training,

- Legal and Regulatory Issues,
- Commercial Real Estate Transactions, and
- Intellectual Leadership.

### ***Institutional Infrastructure***

The Barents team developed a Real Estate Policy and Procedures Manual for the our pilot banks to serve as a standard operating handbook for commercial real estate lending. For the employees of the Real Estate department, Barents provided in-depth training of each chapter of the manual, describing prudent commercial real estate lending procedures from the application to the collection stage. Examples using American and Russian experiences were discussed. Developing such procedures was necessary for ESCB as the majority of their real estate lending experience was with residential lending through the USAID funded programs on housing reform and construction finance.

In order to train the mortgage department's staff, Barents designed and developed three courses and delivered in which the Bank's employees participated. Due to the large distance between Moscow, where the courses were offered, and Irkutsk, the bank was limited in the number of students it could send. Therefore, the Team offered mini versions of the courses in Irkutsk covering many of the most important points of the courses and distributed additional manuals to the staff.

- Commercial Real Estate Lending, 3 (Ludmilla Gorobtsova, Nicoli Kiselev and Tamara Parshena).
- Commercial Real Estate Lending Workshop, 2 (Ludmilla Gorobtsova Nicoli Kiselev)
- Commercial Real Estate Appraisal, 3 (Ludmilla Gorobtsova, Nicoli Kiselev and Anton Barendolts).

These course design took into consideration current Russian legal and economic conditions. Materials provided to the participants included those designed by the Barents team: the Course Manuals, Case Studies, Appraisal Manual, and the Loan Proposal Development Manual, accompanied with a cover letter from the Central Bank's Securities Department. The Team also provided participants with the book, "Income Property Appraisal and Analysis" by authors Friedman and Ordway and four manuals from the Society of Real Estate Appraisers: "A Guide to Appraising Industrial Property", "Shopping Center Appraisal and Analysis", "The Office Building -- From Concept to Investment Reality", and "Hotels and Motels -- A Guide to Market Analysis, Investment Analysis and Valuations". The Team also provided the bank with a book on western accounting principles to assist their underwriting staff.

The Barents team analyzed the Bank's computer application needs, and provided the following types of software models, designed by Barents and Excel based: 1) Discounted cash flow projection and net present value spread sheets, 2) Profit and Loss and Balance Sheet analysis, 3) Construction Budget and Requisition Forms. We

also provided Commercial Real Estate Valuation Software Demonstration Package, designed by ARGUS Company.

### ***Legal and Regulatory Issues***

Barents discussed with the Bank's lawyer (Igor Arhipkin) the current legal situation in Russia regarding real estate transactions, including the legal practices and procedures followed in the Mortgage Department. The Bank has developed a Mortgage Center for the local lenders. Lenders register information about the property and mortgages at the Mortgage Center and are eligible to use the Center to gather information on other properties. The Center was formed out of the Bank's concern that more information needs to be formally recorded and developed on commercial properties. There is a possible solution to most of the Bank's concerns. Specially designed registration software is now in Irkutsk and is in the testing stage .

Barents has provided the Bank with a chapter on the legal issues of Commercial Real Estate Lending, and numerous commercial real estate model bank documents. The documents are designed to protect the Bank against the risk of loss. For example the model credit agreement will contain financial covenants, events of non-monetary default and other new provisions. Furthermore, for construction projects, the documents will provide for assignment to the bank of architectural plans, building permits, and the construction contract in case the borrower defaults during the construction period and the bank must continue with the project. The documents will take into consideration current Russian law as well as the proposed Mortgage and Registration laws, in their current form. Should substantive changes occur in the current law or the proposed text of the Mortgage and Registration Law, legal review and editing may be necessary during the roll-out period. The Bank is aware of this limitation.

### ***Commercial Real Estate Credit Transactions***

There were no CRE loans extended by ESCB during the course of the Project, although several were considered. The Bank did continue to make residential mortgage loans during this time. For the CRE applications, Barents advised the Bank on how to: prepare a collateral appraisal, develop the appropriate loan structure and conduct a project analysis. General market information was also presented for the commercial office market in our pilot cities as there appears to be strong demand for this kind of space in Irkutsk. Barents team members also demonstrated the preferred methods for reviewing business plans and feasibility studies where the emphasis was placed on cash flow analysis and debt service coverage. On two occasions the Team identified errors or omissions in business plans and a revised plan was requested. These appear to be relatively new concepts for the underwriters.

1. *Review the completion of a retail/office project started in the 1980's in the center city, near the oblast administration building.* The Bank was considering this project as either a loan or investment and needed to know how to value the

project. The total rentable area was approximately 3,000 to 5,000 sq. meters, depending on how many units the Bank wanted to finance. The Barents team visited the site without benefit of the proposed plans or drawings. A full scale engineering study is required because of the condition of the shell and reconfiguration requirements. We described how mixed use projects were valued and discussed the information needed to perform a discounted cash flow analysis on the future net operating income. We recommended that a strong partner or guarantor be considered due to the building risk associated with the project.

2. *Review of a \$9,000,000 real estate project involving the completion of an office building with a small retail component, started in the 1980's.* The developer was proposing to finance construction with a \$5,000,000 bank loan and \$4,000,000 in advance lease payments. The proposed budget was expected to cover extensive fit-out plans for the office space. The Barents team reviewed the appraisal, feasibility study and interviewed the developer during a site visit. The team brought certain risks to the Bank's attention including: 1) the developer had never built a commercial project of this size, 2) the feasibility study did not contain all of the costs involved in the project, 3) the asking rents appeared aggressive given the location of the project, 4) the inability of the developer to obtain advance rents of \$4,000,000 would mean additional bank funding would be necessary to complete the project, and 5) there was inadequate developer equity in the project. Before we became involved in the review of this project, the Bank was ready to approve this loan. We recommended that the developer obtain some firm commitments from prospective tenants and advance rental payments before the Bank committed to a construction loan. The Bank followed our advice.
3. *Review of a loan application from an existing business to purchase equipment and fit out retail space for a beauty salon in Irkutsk.* Total amount of the funding requested was approximately \$100,000-\$200,000. The Barents team reviewed the business plan and inspected the building site. The Employment Fund (the Fund) may be a source of funds for this loan because of the number of new jobs created as a result of the project. In this way the Bank can borrow the funds at a low rate of interest and pass the benefit on to the borrower. The team brought to the Bank's attention the following issues: 1) the equity component was inadequate compared to the total cost of the project, 2) the business plan neglected to include certain costs of operation which would need to be calculated before a reasonable determination of net operating income was possible, 3) the floor space may not accommodate the number of employees needed for special funding from the Fund and, 4) therefore, conventional funding may prove too expensive for the cash flow produced. The Bank asked the applicant to revise the business plan and review the plans before submitting another loan request.

### ***Intellectual Leadership***

The need for commercial real estate financing was visibly clear to us on our first visit to Irkutsk as many unfinished real estate projects stood abandoned and the older

buildings needed repairs and rehabilitation. The Bank was anxious to finance these projects but felt constrained by the absence of equity financing. In Irkutsk the government plays a central role in real estate and commercial issues.

Because the Government of Irkutsk plays a central role in real estate and commercial development issues, the Bank arranged meetings with prominent where the Barents team discussed possible solutions, including state financing of privatization sales, state funding for banks at subsidized interest rates, and a municipal bond offering in order to begin to address these issues. . Although the officials understood the need for these programs, the lack of budget funds and the government's need for cash caused us to redirect our efforts.

The Team then introduced the concept of "pooled equity" to the Bank and government officials. Our Corporate Finance Specialist met with them to discuss how marketing attractive real estate projects to investment funds and "pooling" the funds could lead to a material increase in equity for these projects. The oblast agreed and instructed several investment funds to meet with us to discuss "pooling" investment funds for real estate projects. The idea was attractive to the investments funds who are interested in diversifying their portfolios. The investment funds would supplement the bank loan for each project. In this way the much needed equity financing is available for projects and the amount of the bank loan is reduced which means: 1) lower debt service for the project, 2) lower debt to equity ratios, and 3) safer bank loans.

The Sayani Investment Fund in Irkutsk wants to participate in a pooled equity transaction. Sayani is part of PARETET, a large investment fund . Sayani is one of three investment funds in Russia that has been given special status by the Securities Commission to invest in real estate projects and qualify the investors for attractive tax treatment. After several meetings with Sayani, we arranged a meeting with the head of the Investment Division of the Bank, the head of the Real Estate Department and Sayani where the mechanics of a working relationship were outlined. The Bank and Sayani are now ready and willing to participate in a commercial real estate project and pave the way for more pooled equity for projects in the future.

### ***Other***

*Government Participation* - Representatives from the city, oblast and State Property Committee met with members of the team on a regular basis. All three branches of government showed a keen interest in the progress of the Project and shared with us details of transactions, government initiatives and other related projects. Our contacts included Deputy Mayor O'Sherin, Larisa Zabrodskaya, Acting Deputy Head of State Property Management and Deputy Head of the Oblast Committee, and her staff. Ms. Zabrodskaya was actively involved in our Project. She chairs the oblast Committee on commercial development, an influential position as real estate development is a key issue for the oblast and for her committee. Ms. Zabrodskaya has the power to stimulate investment and real estate development and wants investment directed toward the unfinished projects and older buildings. She arranged meetings with

managers of investment funds for the Team as it investigated the feasibility of these funds providing investment financing for commercial real estate transactions. Largely because of these contacts and meetings, we were able to identify a prominent fund that is prepared to invest in real estate projects. Ms. Zabrodskaya likes the pooled equity approach and wants to further support the project by hiring a prominent local business figure to promote the project.

The government is working hard to create more real estate investment in Irkutsk. In July the city hosted a delegation of U.S. investment funds led by the Institute for a Law Based Economy. This group looked at several investment projects and met with the private and public leaders in Irkutsk. The city is also jointly developing property with another bank, Rossiyskiy Kredit, who has started their own investment fund for real estate projects in Irkutsk. The team also established a strong relationship with the Irkutsk branch of Rossiyskiy Kredit Bank. On each visit we met with the Manager and his assistant, who was head of the local Guild of Realtors. The and provided useful information on establishing an investment fund for real estate and also provided market information and analysis upon request.

*Guild of Realtors Presentation* - The Bank requested Barents make a special presentation to the Siberian Branch of the Russian Guild of Realtors. Attendees included representatives from local banks, real estate professionals and government officials. The team gave an overview of the commercial real estate principles covered in the Commercial Real Estate Workshop and discussed general trends in the market. Based on the questions asked at the end of the program, the main concern was the availability of bank credit for CRETs. The Guild is afraid that training by Barents would not solve the main problem, the shortage of funds in the banks to make CRET loans. Unless the banks actually extend loans, the clients are left trying to raise all of the funding by themselves. A shortage of bank credit is felt to be the main reason that projects do not go forward or are not finished.

*Registration* - PADCO is working under a USAID project to modify the registration process in Irkutsk. This project involves recording information into a software system for real estate transactions and includes the registration of real estate mortgages. The Team informed Mr. Kurilov about this project and arranged a demonstration of the PADCO system. One of the members of the Bank's Mortgage Department came to the meeting where PADCO explained the software and its application to the mortgage lending operation. We verified that the system could record the key information points of a commercial mortgage and later briefed Mr. Kurilov.

### ***Benefits of the Project/Recommendations for Further Assistance***

*Organizational Structure* - During the early stages of the project, the Bank was proactive in identifying loan proposals for our review. During this time, the staff was extremely open in sharing the necessary information for us to assist the bank in its analysis. Perhaps this activity would have continued during the entire Project, had it not been for the demands on the staff resulting from foreclosing and repossessing considerable amounts of real estate from previous projects.

The Bank should hire more staff to handle the extra work from the foreclosed loans and allow more time for the staff to address customer needs and train for commercial real estate lending. The Bank may want to consider restructuring its real estate staff into two groups: goods loans and bad loans. This was a common approach for U.S. banks in the early 1990's when real estate problem loans were making it difficult for banks to conduct business. By separating the two areas and hiring more staff, the employees in the "good loan group" have the time to continue to service the good customers and analyze new transactions while other employees in the "bad loan group" work exclusively on the problem loans. If the Bank does not elect to restructure, it will need to hire or allocate more staff should it decide to continue with the Project during the roll-out.

*Policies and Procedures.* The Mortgage Department's level of comfort with residential lending was apparent at the outset of the Project, largely as a result of the Urban Institute Project. This led to a policy decision to learn more about commercial real estate lending and correcting some of the faulty lending procedures of the predecessor bank. This objective was certainly met as the assistance provided covered important subjects, from the basics of commercial real estate lending, to specifics on proposed transactions and collection of the loans through the Manual, training courses, on site advisory and the other real estate resources provided by the project, including software and appraisal books. The Bank shown that when the staff is able to focus on new business, there is a demand from the existing customers for commercial real estate loans.

The Bank must continue to train its new staff on underwriting principles and appraisal techniques for CRE loans. The Policy and Procedures Manual should be made available to the entire lending staff and their understanding of the material be required.

*Transaction Process.* As a result of this Project, sources of equity from Unit Investment Funds were identified to cushion the Bank against risk of loss from highly leveraged projects and significantly reduce the debt service burden on the borrower. In other words all the pieces are in place for the Bank to embark on a successful lending program: the managers of the Department have been trained, a Policy and Procedure Manual has been provided, the Team's transaction advice has taught the staff how to review feasibility studies, and investment funding sources have been identified.

Senior management must continue meeting with managers of the Unit Investment Fund and finalize the procedures for investing into CRE projects. The role of the Bank needs further definition and counsel regarding compliance with tax, securities and  
Central Bank regulations.

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*Summary Report  
Activities with MOSBUSINESSBANK  
as of August, 1996  
Development of a Commercial Real Estate Finance Market  
in the Russian Federation  
Contract No. EPE-0014-I-00-5070-00  
Barents Group, LLC*

**President - Bukato Victor Ivanovich**

**Director of Mortgage Department - Sokolovskaya Galina Anatolievna**

The Barents team has worked with MOSBUSINESSBANK'S Mortgage Department over the course of the project. From the beginning, the employees were highly sophisticated in the fields of real estate, economics, finance and law. This Bank has been the most active and cooperative of all the Pilot Banks. They have made a great effort to attend the classes, have read and implemented the materials within their Department's processes, and have utilized the available resources of the Barents' staff.

Initially, the Team believed that Mosbusinessbank would be among the slowest of the Pilot Banks to issue commercial real estate loans due to their slower progress with other USAID projects. Yet, the Bank was the first to directly implement our policies and procedures within the division and has generated two actual real estate loans as well as the greatest volume of new loan applications secured by commercial real estate.

Key activities and steps are noted below for the main areas of project focus:

- Institutional Infrastructure and Training,
- Legal and Regulatory Issues,
- Commercial Real Estate Transactions, and
- Intellectual Leadership.

***Institutional Infrastructure and Training***

The Barents team developed a Real Estate Policy and Procedures Manual for the our pilot banks to serve as a standard operating handbook for commercial real estate lending. For the employees of the Real Estate department, Barents provided in-depth training of each chapter of the manual, describing prudent commercial real estate lending procedures from the application to the collection stage. Examples using American and Russian experiences were discussed. Upon receipt of each of the chapters, the real estate division of Mosbusinessbank immediately implemented the policies and procedures within the bank. The division showed a marked increase in

the number of transactions it reviewed between the start and completion of our project.

Barents designed and developed three courses and delivered in which the Bank's employees participated. Mosbusinessbank was the most well represented institution at all three courses. The Bank takes its training seriously and dedicates appropriate staff to attend the courses.

- Commercial Real Estate I, 7 people (Aldanov Andrey, Klementiev Oleg, Bagirova Marina, Garelik Ludmila, Stashenkova Natalia, Tvorogov Ilia, Polyakov Oleg),
- Commercial Real Estate Lending Workshop, 3 people (Polyakov Oleg, Stashenkova Natalia, Klementiev Oleg),
- Commercial Real Estate Appraisal, 3 people (Lanetskaya Natalia, Polyakov Oleg, Bagirova Marina).

These course design took into consideration current Russian legal and economic conditions. Materials provided to the participants included those designed by the Barents team: the Course Manuals, Case Studies, Appraisal Manual, and the Loan Proposal Development Manual, accompanied with a cover letter from the Central Bank's Securities Department. The Team also provided participants with the book, "Income Property Appraisal and Analysis" by authors Friedman and Ordway and four manuals from the Society of Real Estate Appraisers: "A Guide to Appraising Industrial Property", "Shopping Center Appraisal and Analysis", "The Office Building -- From Concept to Investment Reality", and "Hotels and Motels -- A Guide to Market Analysis, Investment Analysis and Valuations".

The Barents team analyzed the Bank's computer application needs, and provided the following types of software models, designed by Barents and Excel based: 1) Discounted cash flow projection and net present value spread sheets, 2) Profit and Loss and Balance Sheet analysis, 3) Construction Budget and Requisition Forms. We also provided Commercial Real Estate Valuation Software Demonstration Package, designed by ARGUS Company.

As mentioned above, Mosbusinessbank was the most active bank in calling on Barents experts to assist with project analysis. In addition to the monthly visits, members of the real estate division would often call and request assistance from one of the Team members to assist with an appraisal or an analysis. The on-site advisory provided for the opportunity for the bank to draw on the experiences of the Team in reviewing the transaction, something no course or manual can teach you, only years of experience analyzing, issuing, monitoring and sometimes, working out real estate loans can.

### ***Legal and Regulatory Issues***

Barents discussed with the Bank's lawyer (Pokrovskaya Tatiana) the current legal situation in Russia regarding Commercial Real Estate Transactions, including the status of the land law, mortgage law, land and mortgage registration system, taxation

of real estate, and suggested methods to improve this situation. Bank counsel is most concerned with the administrative process in Moscow for the privatization of real estate. Apparently, there are no standard forms or paperwork for certain functions so the staff must use the residential forms, which are standardized, and make alterations. The privatization certificates themselves often need to be independently verified to determine legitimacy. This makes for a cumbersome closing process where title to real estate is involved. These issues were raised in a separate session was held with Ms. Pokrovskaya and our counsel, Steven Butler. Mr. Butler will include these comments in his recommendations.

Barents will be providing the Bank with a chapter on the legal issues of Commercial Real Estate Lending, and numerous commercial real estate model bank documents that are structured to protect the Bank's interest in case of a dispute or default. The documents will be tailored to the Russian market and reflect prudent clauses for both Western and Russian legislation.

### ***Commercial Real Estate Credit Transactions***

The Barents Team provided assistance to the Bank in analyzing several proposed Commercial Real Estate Transactions. Most often the Team advised the Bank on the collateral appraisals and loan structures (specifically loan to value). General market analysis and information was also provided for retail space (luxury, mid and average types), office space (class A and B) and hotels (luxury and mid-class).

The Bank has been very active, open and cooperative in bringing deals to the attention of the team, requesting its assistance, learning from its advice and implementing its suggestions and other information provided. Of course, several details of the transactions remained confidential, and the analysis was provided without the names of the entities involved.

1. *Review of an \$180,000 real estate loan application to renovate retail space.* The potential borrower purchased retail space comprising 126.6 square meters in the vicinity of Vokovskaya Metro. The Barents team assisted in the review of the collateral appraisal and adjusted the collateral value. The team also transformed the borrower's financial statements to western accounting standards and helped the underwriters analyze the statements. We recommended that loan be rejected due to the borrower's negative working capital position and large accounts payable.
2. *Review of a \$50,000 real estate loan application.* The purpose of the loan was for an interior fit-out package for a 70 square meter Boutique on Tverskaya Street, with a 5 year lease. Our first task was to assist in the collateral appraisal. After the investigation and appraisal, we concurred with the Bank's idea of dividing the loan into two parts: a loan secured by the Boutique's inventory, and a loan secured by the leasehold estate. The loans have been cross-collateralized approved and disbursed.

3. *Review of a loan restructuring for a food store, Korablik (Small Ship).* The original purpose of the loan was to expand production facilities and to purchase inventory. The borrower was experiencing trouble repaying the loan and we worked with the Bank to identify additional security, including mortgage collateral. We assisted in the appraisal of the 1039 square meter facility, using cost, market and income approaches, and recommended that the property be used as additional collateral for the loan. All parties agreed and the loan was then restructured.
4. *Review of a loan application for retail space in a large mixed-use structure near the Garden Ring, north west of the Kremlin.* We assisted in the appraisal of the space, valued at \$25 million, based on a discounted cash flow analysis that we calculated and shared with the bank. The borrower needed money for a tenant fit - out package, for a bank, a restaurant and several exclusive retail boutiques. This building is included on the government's list of architectural and historic properties to be preserved. We advised that the loan structure was acceptable from a collateral standpoint as the loan to value was 25%, and the risks were appeared low. However, we were not allowed to review the overall cash flow situation of the borrower or guarantor. The loan was part of a large facility under consideration by the Corporate Department and the Mortgage Department's involvement was restricted to the collateral value. No final decision had been relayed to us but recently we visited the site and there was substantial amount of contracting work is in process on the floors that we appraised. It would seem to us that the loan was approved.

### ***Intellectual Leadership***

The Barents Team conducted research in the real estate market and presented a Pooled Equity Brochure and explained the concept in-depth to the Mortgage Department. Ms. Sokolovskaya was extremely interested in the idea and discussed with the teams the best structure and project size for such a fund. The Team suggested that the Bank should start small, possibly with one or two other investors and in a smaller deal in order to gain experience in such transactions and to build the level of confidence within the bank for pooled equity. The Bank could continually build on their transaction experience by building a larger pool and expanding their investments to larger and/or several projects within a fund.

Ms. Sokolovskaya took this idea to the President of the Bank and the Board of Directors to receive their approval. The Team recommended the Bank hire an expert in investment funds to advise the bank on legal and tax implications.

### ***Benefits of the Project/Recommendations for Further Assistance***

*Policies and Procedures.* The Bank now has the Policies and Procedures Manual to assist them in modifying their current policies and procedures from strictly residential to including commercial real estate. The staff has also worked with the Team to

analyze several CRET applications and has approved loans which has provided it with a working base to modify the procedures based on the Bank's actual experience. The Bank will need to periodically review their policies and procedures to ensure that they are being followed and add/delete the appropriate provisions.

*Appraisal and Underwriting Expertise.* The staff appraiser and underwriter have the necessary training and working knowledge to properly appraise/underwrite commercial real estate. The staff should continue using the appraisal techniques on actual loan applications. Periodic training is important for these two positions. The Argus software provided to the bank by this contract should assist in automating the process.

*Transaction Process.* The Bank has been proactive in utilizing the information that we have provided via the manual and course offerings, putting that information into practice. The Bank has actually approved and disbursed CRET loans and is now "in the market". The Department should proceed cautiously. Small to medium size transactions with at least 50% equity participation are excellent teaching tools until the staff has the experience and expertise necessary for the larger transactions.

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*Summary Report  
Activities with Stolichny Bank of Savings  
as of August, 1996  
Development of a Commercial Real Estate Finance Market  
in the Russian Federation  
Contract No. EPE-0014-I-00-5070-00  
Barents Group, LLC*

**Andrey V. Podkolzin, Director of Real Estate**  
**Sergey O. Gandzuck, Chief Economist**  
**Dmitry V. Losev, Real Estate Expert**

Early on, Stolichny Bank became one of the most active participants in the Moscow real estate market. The senior management realized that joining forces with developers and the Moscow City Government would be a profitable venture and the Bank acquired and developed prime real estate for investment purposes. On the financing side, senior management established the policy that real estate loans would be issued only if the collateral securing the loan could be used by the bank in the event of default and foreclosure. Using this strategy Stolichny Bank approved \$20 Million in real estate loans and accepted the risk that it could become the owner of real estate in various stages of completion, renovation, and lease-up.

During the program's tenure, the Bank underwent a comprehensive reorganization and restructured the Real Estate Department. The Division was actually upgraded to a Department, giving it more stature, responsibility and direction. In the initial stages of the program, the Bank requested guidelines to support the growth of the real estate business. This specific support included a new policy and procedures manual, forms and documents to structure real estate transactions and targeted training for their branch employees and new staff members.

The project directly coincided with a visible increase in the amount of real estate transactions the Bank was involved. The Bank did not make use of Barent's advise for the transactions and instead forged ahead under pressure from senior management. In retrospect, the senior managers realized that if they had relied on Barent's consultations, they could have avoided many of the problem situations they are now facing.

The Project was timely in that Barents introduced concepts of attracting liquid assets to develop real estate and supplement limited bank funds with equity investments for real estate projects. More specifically, the team introduced pooled equity and debt structures, real estate investment trust arrangements and loan workout and collection strategies for commercial real estate projects of the Bank.

Principal activities and steps with Stolichny Bank are noted below for the main areas of project focus:

- Institutional Infrastructure and Training,
- Legal and Regulatory Issues,
- Commercial Real Estate Transactions, and
- Intellectual Leadership.

### ***Institutional Infrastructure and Training***

The Needs Assessment part of the project identified this area as the most important for the Bank. Senior management intended to grow the CRE division, and in fact, during the course of the program, the division was upgraded to a department, in terms of responsibility and size. As such senior management had neither the time nor the expertise to provide training to their new recruits.

The Barents team developed a Real Estate Credit Policy and Procedures Manual for Banks in the Russian Federation. Barents provided the chapters of the manual, which described prudent commercial real estate lending procedures from the application to the collection stage. Examples using American and Russian experiences were noted.

Barents designed and developed a Commercial Real Estate Lending Workshop, especially for the Stolichny Bank real estate department and branch employees. The workshop incorporated case studies for the bankers to practice their underwriting, analysis, and negotiating skills, and took into consideration current Russian legal and economic conditions.

This course was particularly relevant for the bank, as the branches were experiencing repayment problems in their real estate portfolios. The branches were previously given responsibility for the decision making process of underwriting and issuing loans. However, management soon realized that the branch managers were unskilled and needed additional training.

Materials provided to the Bank included those designed by the Barents team: the Course Manuals, Case Studies, Appraisal Manual, Loan Proposal Development Manual. We also provided the book by authors Friedman and Ordway, "Income Property Appraisal and Analysis".

The Barents team analyzed the Bank's computer application needs, and provided the following types of software models, designed by Barents and Excel based: 1) Discounted cash flow projection and net present value spread sheets, 2) Profit and Loss and Balance Sheet analysis, 3) Construction Budget and Requisition Forms. We also provided Commercial Real Estate Valuation Software Demonstration Package, designed by ARGUS Company..

### ***Legal and Regulatory Issues***

The Barents legal advisor met with the legal department of the Bank, lawyers who were responsible for all aspects of secured lending, from loan documentation to enforcement actions in court. The Barents legal advisor focused on the following questions:

1. What does the Bank perceive as the major problems in making loans on commercial real estate - land, lease rights, city approvals, enforcement?
2. What is the best way to secure loans today?
3. Have they enforced a loan in court and what are the problems?

Discussion of the particular problems of leasehold mortgages led the Team Advisor to recommend that localities need to develop better policies on mortgaging their leases and to recommend an addition to a Banks documents to include a section on the type of agreements a lender would want from the owner of a leased property.

Representatives of the Bank expressed satisfaction with Moscow's privatization procedures and documentation, registration and obtaining city approval for mortgaging lease rights. The Bank's satisfaction with these issues was attributed to a close relationship with the city administration and diligence in mastering the procedures. In fact, while aware of the many flaws in the current legal regime, the Bank appeared to view few of them as insurmountable and attributed slow growth of mortgage lending to other factors - including lack of liquidity and the attractiveness of other investments.

Although the Draft Law on Mortgage is a welcome addition to the law, the Bank's lawyers were already comfortable taking as real estate as collateral for a mortgage loan. Their comfort lay in their interpretation of the current law, specifically the Civil Code and the Law on Pledge, which provides the Bank with mortgage rights for properly executed mortgages. Stolichny was one of the first Moscow Banks to secure loans with mortgages and to develop a reliable documentation process for proving title.

Barents will be providing the Bank with a chapter on the legal issues of Commercial Real Estate Lending, and numerous commercial real estate model bank documents that are structured to protect the Bank's interest in case of a dispute or default. The documents will be tailored to the Russian market and reflect prudent clauses, for real estate lending that are consistent with the proposed legislation on Mortgage and Registration.

The Bank is updating its "reference guide for documentation and registration of mortgages". Its lawyers are auditing the mortgage documentation process in their 10 branches and will determine if the branch managers are following the recommended procedures. The Bank will use the Barents Manual and specifically the legal chapter to make other changes to their reference guide.

### ***Commercial Real Estate Credit Transactions***

As one of the major players in the Moscow City CRE market, the Bank has acquired and developed prime real estate for investment purposes. On the financing side, senior management established the policy that real estate loans would be issued only if the collateral securing the loan could be used by the bank in the event of default and foreclosure. Consequently, the Bank's CRE transactions consist of property under development and also existing improvements.

As with the other banks, the Barents Team provided general market analysis and information for retail space (luxury, mid and average types), office space (class A and B) and hotels (luxury and mid-class). Specific appraisal techniques were recommended to the department for single and multiple use properties. This information and advice helped them increase their understanding how to fully analyze the market demand for a transaction and analyze a project's potential value.

In general, the Bank did not use the Team's expertise to consult on specific transactions. The Bank discussed several projects financing structures, conceptually, which helped them increase their understanding of how to attract funding from other sources and how to work themselves out of a problem situation.

- *Multi-Property Syndication.* The Team was asked to comment on a confidential undertaking involving the Bank and the City of Moscow. The City requested the Bank lead a \$500 million syndication of Russian Banks to build out 500,000 square meters of commercial space in central Moscow to coincide with the City's 850th birthday in 1997.

The Team emphasized ways that the Bank could earn fee income by providing valuable services. The services enumerated included organizing the syndication, handling the loan administration, and monitoring the construction process through contractor selection, draw requests, progress and site inspections, collecting loan repayments and allocating payments to the Bank Group. These project specific duties for the lead bank could translate into a smaller percentage of the agent Bank, in this case Stolichny's, loan funding. They could also earn fee income from the City and from the Bank Syndication Group for services rendered. The Team also recommended that the city should guaranty loan repayment and guarantee payment of the Services provided. The rationale for this was that the City would benefit as the owner of the income producing property and therefore provide these guarantees to the Bank and Bank Syndication Group.

- *Retail Property.* The Team was asked to opine on a problem loan secured by real estate where the Bank was in the foreclosure process. The collateral was a nearly completed retail property with a commercial component located in an attractive shopping district in Moscow. After foreclosure, the Bank's options included either selling the property or completing construction, leasing the facility and collecting the rents. Barents shared the pros and cons gleaned from the American experience, and recommended sale of the property because Banks were not in business as construction managers, leasing agents or landlords.

### ***Intellectual Leadership***

Methods of attracting additional funding sources were an important component for this Bank's development program. One way discussed for the Bank to diversify and liquidate its real estate investment portfolio and obtain financing for future projects was to selling shares or participations to other investors and sharing the income from the properties on a pro-rata basis. Another method discussed was to create an investment company with pooled equity funds or with debt from a syndication of lenders; this investment company would buy a large percentage of the Bank's portfolio.

Stolichny considered these new methods of funding equity investments in real estate projects through shareholder offerings. The U.S. National Association of Real Estate Investment Trusts presented an information package outlining the benefits of forming real estate investment trusts (REIT), the procedures for forming REITS, and the U.S. disclosure requirements. The brochures and manuals provided the tools to deepen their understanding of the concept.

The Team continued discussions about implementing the concept of pooled debt and equity funds regarding two of Stolichny Bank's properties. The first was a nine story residential apartment house, with a commercial and special use component, including a garage and school. The property is completed, but sales are slower than expected. Stolichny believes a fund could include this property in its portfolio. The second was a resort center, in the Moscow Oblast. Questions regarding the highest and best use of the property were discussed. Barents suggested several options they should consider, including a private school. A study of recent market research showed there were no other schools located in this region and there was an increase in the number of school children relocating to the area..

### ***Benefits of the Project/Recommendations for Further Assistance***

*Funding Sources.* The Bank benefited from the knowledge transferred regarding the methods of attracting funds for both its own and customers' projects. Barents presented the concept of pooled equity/debt structures, which walked the real estate managers through the basic steps of syndicating the real estate portfolio. Through the Commercial Real Estate Lending Workshop, Barents informed the participants about the procedures for "working-out" problem loans, and introduced them to the case study method that provided actual practice in analyzing various loan situations.

We recommend continued advisory services relating to the Bank's divestiture of its real estate portfolio, syndication of its real estate investments, and restructuring of its problem loans and equities. As Stolichny has a large portfolio of real estate assets, it must convert these investments and credits into liquid assets and these approaches should be pursued by the Bank during the Program's roll-out phase.

*Procedures.* The Commercial Real Estate Policy and Procedures Manual was useful as it added to their existing bank policies and procedures concepts from a commercial

real estate perspective. Further assistance is recommended to assist the Bank in fine tuning their existing policies and procedures to incorporate commercial real estate transactions.

*Transactions.* This was the area that the Bank acknowledged they should have used more. As one manager retorted, "Had they used the advisory services of the Team in their attempts to grow their Department, they would not have the problems they are currently facing." We recommend that future work should include assistance in underwriting and structuring deals.