
REPORT TO USAID, RPC AND GKI

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

*Contract No. EPE-0014-I-00-5070-00
Task Order No. 1*

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February 13, 1996

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**PART A:
CITY AND BANK SELECTION**

I. Overview and General Approach

We propose to work in three cities with a total of four pilot banks:

<i>Cities Selected</i>	<i>Moscow (2)</i>	<i>St. Petersburg (1)</i>	<i>Irkutsk (1)</i>
<i>Banks Selected</i>	Stolichny Bank MosBusiness	Bank St. Petersburg Promstroi Baltiyskiy	Eastern Siberian Commercial Bank

Our city and bank selection was circumscribed by the following:

- The need to find a city that met the city criteria and had a bank that met the bank criteria.
- Limited time.

Consequently, we relied on the advice and information provided by other contractors in determining initially which cities to visit, and we focused on cities that were known to have a “good” bank. Moreover, we sought to find 4 cities that appeared attractive, and visited those; we did not visit 10 cities and plan to pick the best four. Clearly there are other cities and banks that would be acceptable for the program, and as good as the ones suggested here.

II. City Selection

A. City Criteria

Our city criteria had three main elements as shown below and as described more fully in the attached table:

<u><i>City Officials</i></u>	<u><i>Infrastructure</i></u>	<u><i>Economics</i></u>
Their willingness to participate in the program, how reform minded they are, and their ability to pass local legislation.	Specifically, the existence of a functioning registration system, preferably with REIS assistance but not necessarily.	Specifically, the number of privatized enterprises and land, and commercial development in process and perceived market opportunities.

Although all criteria were not weighted equally, many were important and we looked for cities that had a receptive and reform minded government, significant privatization, a functioning registration system, and strong economic base that would support commercial real estate financing in the future, even if such financing was not strongly in demand today.

In each city selected, we expect to perform the following, as described in the attached list of activities and workplan:

- Assist in identifying obstacles to providing financing for CRETs by financial institutions in the local area.
- Assist in drafting policies, legislation, and regulations to fill in the gaps left by existing or absent national legislation.
- Assist in making the registration system work for commercial real estate.
- Identify new financing techniques that might be used.

In doing this work, we will coordinate closely with Housing Finance lawyers, ELS, REIS, and other relevant parties.

CITY SELECTION CRITERIA

CITY OFFICIALS

Willingness to participate in program

- Willing to participate in the program
- Willing to commit necessary resources
- Open to foreign technical assistance
- Creative and willing to introduce change to improve existing practices

- Ensures commitment for cooperation by senior governmental officials so that we can quickly implement the needed changes

Reform-minded city government officials

- Proactive in their city's development
- Supportive of reform minded projects, *ie.* housing reform, privatization, urban planning reform, taxation, etc.

- More likely to take needed steps to facilitate CRETs

Willing to pass local legislation

- Willing and able to take initiative on legislative and registration reform
- Have a record of approving documents and/or laws regulating local mortgage lending and registration

- Helps ensure we can propose and hopefully pass legislation necessary for CRETs

INFRASTRUCTURE

Registration system in place through participation in the REIS project or by other means

- Has a functioning registration system developed through the REIS project, or independently
- Information available on properties registered includes: land plot, structures, sales results, prior liens and encumbrances
- System is capable of or being modified to register CRETs
- Governments capability and experience in registering and releasing mortgage transactions

- Registration and information will be less of an obstacle to transactions

ECONOMICS

The number of privatized enterprises, land and residential properties

- Number of enterprises with privatized land sites
- Extent to which land is owned and where sites are available for private ownership
- Commenced sales of land on which privatized enterprises are situated
- Extent of housing/apartment privatization

- Indicates economic strength of a city or region
- Indicates city's dedication to privatization
- Gives a general understanding of the types and viability of CRETs that can take place

Commercial development in process and perceived market opportunities

- Extent of commercial real estate development activity
- Potential for growth
- Market demand and types of demand (office buildings, retail shops, business centers)

- Economic opportunities will influence the demand for commercial real estate finance

B. Cities Suggested

The three cities suggested are Moscow, St. Petersburg, and Irkutsk. Moscow has the most active banks with the greatest roll-out base. St. Petersburg is the second largest Russian city which is interested in developing more financing for CRETs but needs assistance. Irkutsk is a small, economically dynamic city with a very reform minded government and attractive bank. Novgorod and Pskov were also considered.

I. Moscow--Moscow is suggested because it has the greatest economic and commercial real estate activity in Russia and the largest and most active banks with the largest branch networks. This provides a basis for a strong roll out program and for understanding and identifying new financing techniques for Russia. The city may not be easy to work with on legislation and registration. Consequently, we will focus mainly on banking issues. Overall, the city meets several of the city selection criteria.

City Officials

Though we have not spent time with Moscow city officials, information received to date suggests that it may be difficult for our team to influence local authorities and we would be better to use our resources elsewhere. Many of the important related projects (ELS, REIS, Land Use, Property Tax) are not operating in Moscow. However, we will do the best we can to work with city officials.

Infrastructure

Moscow has a functioning registration system, although it has problems

Economics

Moscow is by far the most active Russian city in terms of the demand for and construction of commercial real estate.

2. **St. Petersburg**--St. Petersburg meets several of our criteria. It is the second largest city in Russia with potentially strong demand for financing and a receptive and reform minded local government. However, banks are reluctant in today's environment to finance many CRETs for economic and other reasons. The city and its banks can profit from the new skills and information provided by our team.

<i>City Officials</i>	<i>Infrastructure</i>	<i>Economics</i>
City officials appear to be reform minded; have developed committees and drafted legislation to address holes left by federal legislation; have privatized a large number of enterprises and land; have two important USAID projects operating there (ELS and Land Use Zoning); and welcome our assistance to address problems. They are working on registration as well (see side).	St. Petersburg has a registration system, though it is dispersed and bureaucratic. REIS is helping to organize activities. A St. Petersburg official informed our team that the city is working to have a fully functioning registration system which will cover commercial real estate by the second half of 1996 and to reduce the bureaucracy.	There is considerable demand in St. Petersburg for commercial real estate renovation and construction, but as in other cities high interest rates and legal problems constrain financing. St. Petersburg is having some concern difficulty transitioning from a defense-based to diversified private economy.

3. **Irkutsk**--Irkutsk was strongly recommended by several parties (including Housing Finance, 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 caused us to put Irkutsk high on the list of cities to visit.

<i>City Officials</i>	<i>Infrastructure</i>	<i>Economics</i>
Irkutsk's city officials are highly reform minded. The oblast was one of if not the fastest to implement the privatization programs in Russia. City and oblast officials are trying to deal with the absence of important national laws for commercial real estate and are drafting a Mortgage Law for the oblast. Irkutsk was one of the first oblasts to reduce price controls. The Land Use Zoning project is operating there.	Irkutsk is not a REIS city. But it has a functioning registration system that can be used for commercial real estate and that appears as usable as registration systems in cities where REIS is in its initial stages. The Eastern Siberian Commercial Bank has developed a Mortgage Center (available to other banks) that registers real estate pledged as collateral for bank loans.	Irkutsk has a strong economic base (of oil, hydropower, timber, and tourism) and last year was a net contributor to the national budget. The strong economy is an important attraction. Although financing CRETs is not sizable now, it is mainly due to high local interest rates. There appears to be demand in the city for commercial real estate development.

4. *Novgorod*--Novgorod was considered as a possible pilot city as several USAID projects are operating there. The city met several of our selection criteria. However, as discussed in the section on banks below, the area's largest bank is not financing CRETs (which is limiting land and enterprise sales in the area), and indicated it would not do so until a national Mortgage Law is passed. For this reason, Novgorod is not suggested as a pilot city.

<i>City Officials</i>	<i>Infrastructure</i>	<i>Economics</i>
City officials are said to be reform minded and interested in real estate reform projects. They have embarked on a large survey program which will establish more certain property data which will assist buyers, sellers, and lenders.	BTI's property file has been described as very thorough. The registration process is capable of registering properties but a REIS-type system would allow BTI to access more property information from other municipal entities and provide better information to the users.	Novgorod has a strong commercial and industrial base (consisting of manufacturing, oil products, a wholesale industry).

5. *Pskov*--Pskov was also visited by the team but it was decided not to pursue work in Pskov because of the limited market opportunities and the lack of banks experience or active in commercial real estate transactions.

Outside Links: USAID and other Donor Projects in Cities of Interest

	<i>Housing Finance</i>	<i>ELS</i>	<i>REIS</i>	<i>Land Use Zoning</i>	<i>Property Taxation</i>	<i>World Bk Twinning</i>
<i>Moscow</i>	3	0	0	0	0	2
<i>St. Petersburg</i>	2	1	1	2	0	2
<i>Irkutsk</i>	2	1	0	2	1	0
<i>Novgorod</i>	3	2	1	2	0	0
<i>Tver</i>	1	2	2	2	1	0
<i>Pskov</i>	1	2	2	0	1	0
<i>Nizhny-Novgorod</i>	1	1	2	2	1	0

III. Bank Criteria and Selection

A. Bank Criteria

Our bank criteria had three main elements as shown below and as described more fully in the attached table:

<u><i>Management & Organization</i></u>	<u><i>Transaction Experience</i></u>	<u><i>Outside Links</i></u>
This refers to the bank's willingness to participate in the program, management expertise in general and specific to commercial real estate finance, and branch network. The latter is important for the roll-out program. Perceived financial stability was considered as well.	Specifically, the extent to which the bank is already financing commercial real estate transactions, or has construction and residential real estate experience that would serve as a basis for developing commercial real estate financing capabilities.	Specifically, participation in other donor programs (i.e. Urban Institute's Housing Finance, the World Bank's Twinning Program or programs with The US-Russia Investment Fund). This suggests a strong interest in developing skills, and in some cases the actual development of those skills.

In addition, we only considered banks which were headquartered in the cities visited, on the assumption that branches of larger-city banks would be part of their program through their headquartered operations and because in many cases the branches are not able to make lending decisions independently. As stated earlier in this report, our goal was to select banks that would qualify under our criteria after fair consideration of their real estate capabilities and certain performance standards. Although the selected banks are among the best banks in the selected cities, senior management officials did feel that exposure to the Project would provide material assistance to their CRE capabilities.

B. Moscow Banks Suggested and Not Suggested

We interviewed five banks in Moscow and suggest working with two banks--Stolichny Bank and MosBusinessBank--as they present the project with different working relationships and opportunities. Stolichny Bank is well advanced. It will be a useful bank for obtaining ideas and information about financing CREs in Russia and for rolling out the project. MosBusinessBank is less

BANK SELECTION CRITERIA

MANAGEMENT & ORGANIZATION

Willingness to participate in the program

- Willing to participate in the program - Sr. Management
- Willing to commit necessary resources
- Open to foreign technical assistance
- Creative and willing to introduce change to improve existing practices

- Will enable us to begin to work quickly and effectively with the banks and insure that we are able to make the needed changes. A senior management commitment is vital.

Management Expertise

- Have in-house qualified professionals familiar with credit and underwriting analysis, asset/liability management, collateral valuation, and legal issues
- Have an operating commercial real estate division or unit
- Management very knowledgeable about CRETs

- If management is knowledgeable about CRETs, more can be achieved in the limited time frame. Can build on current knowledge and skills.

Perceived Financial Stability

- Perceived as a strong bank by the market
- Perceived as a strong bank by other USAID and other donor funded projects.
- Adequate capitalization

- Increases bank's ability to attract quality clients and funding at a reasonable cost, and to the extent possible, offer reasonable maturities

Branch Network

- Have an extensive branch network

- The larger number of branches the larger the potential roll-out

TRANSACTION EXPERIENCE

Existing commercial real estate finance orientation

- Already booking CRETs

- Can concentrate on improving current processes and documentation and expanding current ideas for CRETs

Residential and/or construction lending

- Already executing these transactions

- Already familiar with real estate-related issues *i.e.* property appraisal, collateral documentation, credit analysis, etc. Can build on current skill base.

OUTSIDE LINKS

Participation in other donor agency programs

- Participation in such projects as the World Bank FIDP program, EBRD programs, etc.

- Have demonstrated a desire and/or an ability to compete on an international basis.
- Many projects pre-screen for financial soundness.
- Are open to foreign technical assistance

Participation in other USAID programs

- Participating in such programs as the Urban Institutes project for Housing Reform, the U.S. Russian Investment Fund, etc.

- Understand the resource commitments necessary and are open to new ideas. For Housing Reform, would be able to take advantage of synergistic benefits of working on both projects.

Strong relationships with real estate community

- Strong relationships with developers, contractors, insurance companies, associations and guilds.

- Bank management is able to discuss ideas with critical players in market.

advanced and will provide an opportunity for the Project to assist in helping to develop a far broader range of the bank's capabilities for financing CRETs.

I. Stolichny Bank -- Stolichny Bank is considered one of the more active banks in the commercial finance market and has real estate professionals with an impressive understanding and awareness of the issues. Stolichny is considered "solid" yet careful with regard to its' commitment to this new and exciting market. The bank scored the highest on the banking criteria employed:

<u>Management & Organization</u>	<u>Transaction Experience</u>	<u>Outside Links</u>
Stolichny scored the highest or second highest in every subcategory. Management is well informed about the commercial real estate market in Moscow, and would like to use the program to train staff throughout its branch network in financing CRETs. It presents a strong opportunity for a roll-out program.	The bank has considerable transaction experience, and has provided financing for several different types of transactions.	Stolichny is in several relevant programs (i.e. Urban Institute's Housing Finance and the World Bank's Twinning Program). The sponsoring groups speak highly of the organization and its management.

Stolichny's strong positioning in real estate matters relative to the other banks will call for a slightly different consulting schedule in terms of content and timing.

2. ***MosBusinessBank***-- MosBusiness is a long-standing and respected institution. It has a conservative lending strategy but an effective plan to aggressively attract professional assistance on real estate lending issues, and a strong¹ 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 contribute to our suggestion of MosBusiness as a pilot institution.

<i>Management & Organization</i>	<i>Transaction Experience</i>	<i>Outside Links</i>
The bank has strong management and a Mortgage Department whose head is active in relevant legal reform issues and is a member of the working group on the Law on Mortgages. The bank expressed strong interest in working with our Project. Its branch network is somewhat smaller than other Moscow-based banks.	The bank has some but limited experience financing commercial real estate transactions.	MosBusiness is in the Urban Institute's program and has been placed on the short list of approved banks for the "Twinning Program" involving the World Bank.

Three additional banks were interviewed but are not suggested. They are:

- ***MOST Bank***--MOST Bank met the majority of our selection criteria. They have extensive transaction experience in residential and commercial properties; highly qualified personnel in construction and housing finance; in-house experts on collateral valuation. Their management and grasp of the issues is impressive. However, we were concerned about the bank's tight ties to a real estate development firm and to some extent felt that the bank would benefit less from our program than other Moscow banks.

¹ Typically, professional training of a bank's staff on a new lending market is essential before any meaningful amount of lending should take place. On the surface, this rule is nothing more than simple logic. Unfortunately, many banks do not follow this simple logic and hurt themselves in the process as it almost invariably leads to portfolio quality problems. Disastrous consequences from uninformed lending decisions are a world-wide banking problem. Risk Management techniques *do allow for modest levels of lending while training and procedures are in process, if the process is well conceived and disciplined.*

- *Rossiyskiy Kredit* --Although Rossiyskiy Kredit met several of the bank criteria, it did not score highly on the whole. It is waiting to hear if it has been accepted into the World Bank's twinning program. Our impression was that the bank was not as interested in working with our program as other banks. Thus, it is not suggested.
- *TverUniversal* --TverUniversal is headquartered in Tver, which is one strong reason for not choosing it as one of the Moscow banks. In addition, there may be some financial concerns with the bank.

C. *St. Petersburg*

St. Petersburg has sizable banks with strong reputations, which was an important reason for focusing on the city. The banks are very supportive of the commercial and industrial sectors and have a branch delivery system second only to Moscow. Land is freely conveyed in St. Petersburg which broadens the scope of CRET collateral. Moreover, the banks expressed concern about their ability to finance CRETs in the current economic environment. However, several of these concerns can be reduced through our program's assistance. Several banks were interviewed during a November visit, but three were focused on during a January visit as they appeared to be the strongest. We suggest working with one bank in St. Petersburg, and then providing the documents and information to perhaps a second bank. Below is information on the three banks visited. At this point, we suggest choosing between Bank St. Petersburg or Promstroi Bank.

I. *Bank St. Petersburg* --In a market marked by several recent bank failures, Bank St. Petersburg stands out as a solid leader and meets several of our bank criteria:

Management & Organization

The bank has expertise in real estate lodged in both a Mortgage Department and an Investment Department. Commitment to the project was given from the highest levels of the institution.

Transaction Experience

Our meetings indicated that the bank has successful real estate experience for the transactions undertaken. Also, senior management appear well versed on the issues. While the bank expressed concern about doing transactions today, given the economic environment, it is very interested in finding ways to resolve those problems and obtain greater capabilities for doing transactions.

Outside Links

The bank has experience in all of the preferred banking programs. It feels that the project would assist in attracting foreign correspondent participation in CRETs. In other words, the more knowledgeable the bank is on CRET issues, the more likely it can attract a foreign lender to participate in the transaction.

2. *Promstroi*--As a former commercial and industrial bank, Promstroi has long standing banking experience and familiarity with CRETs. Like the previous bank, Promstroi is regarded as a stable institution.

<i>Management & Organization</i>	<i>Transaction Experience</i>	<i>Outside Links</i>
Promstroi scored well in three of the four areas. The bank set up a Mortgage Department about six months ago which appears well managed.	Although the pace has slowed, the bank was approving and therefore has in its portfolio CRETs. Staff were open about procedures and interested in improving the existing processes.	Promstroi participates in all of the relevant programs and generally has a good reputation with the contractors. Again, getting foreign correspondents to participate in local CRETs is an objective.

Overall, we find very little difference between Promstroi and Bank St. Petersburg for the purposes of this project. Both are well managed and respected institutions. Both are working with the Urban Institute's Housing Finance Program and the World Bank. While Promstroi may be advantaged given its long years of financing commercial and industrial projects, Bank St. Petersburg appears more knowledgeable on CRET issues and obstacles (which may have reflected the fact that we met with higher level persons at Bank St. Petersburg). We believe that either bank would be a fine selection.

3. *Baltiyskiy Bank*--Baltiyskiy Bank is a newer bank in St. Petersburg with a reputation for being innovative and progressive. To a lesser degree, the bank has Management and Organization experience with CRETs; it does not have the same level of Transaction Experience as the other two banks. The bank does participate in donor agency programs but is not, as yet, on the final list for the Twinning Program. Given these factors, and the state of the local economy, we might prefer to select one of the more established banks above.

D. Irkutsk

Our team focused on Irkutsk because of the positive information relayed from the Housing Institute, Enterprise Land Sales, the U.S. Russian Investment Fund and other sources about the region's political stability, economic strength, and the existence of an attractive bank. The Eastern Siberian Commercial Bank was suggested as a pilot bank by several sources for reasons noted below. ESCB is the most active bank headquartered in Irkutsk, but the branches of Moscow banks are more active in financing CRETs.

In addition, the local Rossiyskiy Kredit branch is very interested in our program, as is the local Guild of Realtors. We envision working closely with both to increase the dissemination and training from our program to local entities and vice versa. Overall, working in Irkutsk would enable the team to "roll out" approaches and ideas from Moscow to a far different part of the country during the pilot stage.

I. Eastern Siberian Commercial Bank--This is yet another former commercial and industrial bank with a long history of working with the commercial sector. The bank has financed CRETs involving the largest privatization projects in the region. This is the only bank where the Chairwoman not only met with our team, but spent nearly two hours discussing CRET issues and solutions, indicating strong commitment to the project.

Management & Organization

One of only two banks to score perfectly in this area. The Chairwoman sits on numerous legislative committees and trade associations. She is actively involved in finding ways to improve the ability to finance real estate transactions and even established a Mortgage Center for registering real estate pledged as collateral for bank loans, a service made available to other banks in Irkutsk. The bank is the only bank headquartered in Irkutsk with a separate branch that handles real estate transactions.

Transaction Experience

Although CRET business has slowed, the department seems well-positioned to complete the Project and handle a larger volume of loans. It has experience in financing residential real estate.

Outside Links

ESCB has suddenly become the focus of several foreign assistance programs. In addition to the Urban Institute's presence, the bank is being considered to receive funding from The US-Russia Investment Fund for further developing its residential mortgage lending, and from non-US sources as well for investment and credit development. Other international assistance programs are active. These programs are helping to strengthen the bank's capabilities and in some respects reduce its funding costs (in cases where donors provide funds at preferred rates).

As noted in the City Selection suggested, REIS is not operating in Irkutsk. However, the city has its own registration system, which needs to be upgraded but is probably as useful as the registration systems in many of the cities where REIS is in its initial stages of operation.

E. Novgorod

Novgorod was considered because of the presence of Enterprise Land Sales and other AID Programs in the city. The city has a large population base and commercial activity. However, only one bank of any size operates in this market.

1. Novobank—This bank has the confidence of the oblast and the city, as they deposit large amounts of funds in it on a regular basis. Moreover, city officials speak highly of the bank. Unfortunately, the bank may be set on rejecting CRETs until the National Law on Mortgage is passed, which would make it difficult to suggest working with this bank in our program.

PART B: PROJECT IMPLEMENTATION

I. Task Descriptions and Teams--The team will be based in Moscow and will perform the following tasks:

	<i>Banking</i>	<i>Legal/City</i>	<i>Corporate Finance</i>	<i>Other</i>
<i>Main Tasks</i>	<ul style="list-style-type: none"> • Develop internal procedures manual, business and legal documents. • Provide on-site and classroom training. • Identify software for CRETs operations. • Assist in identifying borrowers (work with ELS). • Plan roll out. 	<ul style="list-style-type: none"> • Assist pilot cities in identifying and addressing problem areas. • Participate on working groups for addressing national legislation. • Advise team members on legal issues concerning banking documents and proposed financing techniques. • Provide training. 	<ul style="list-style-type: none"> • Evaluate current techniques for financing CRETs. • Evaluate techniques that firms would like to use but feel cannot. • Suggest new approaches that might be used given legal, funding, and other obstacles. 	<ul style="list-style-type: none"> • Assist REIS and/or local officials in modifying local registration systems to support commercial real estate. • Train local administrators in new registration techniques (working with REIS where possible).
<i>Approach</i>	<ul style="list-style-type: none"> • Work closely with each pilot bank on implementing new procedures and documents. • Build from UI documents and procedures where possible. • Build from UI training where possible. • Work with ELS to identify borrowers. 	<ul style="list-style-type: none"> • Develop relations and work with Russian lawyers (at banks, law firms, city) in each pilot city. • Participate on local working groups for national legislation. 	<ul style="list-style-type: none"> • Interview and develop dialogue with investment banks, investment funds, realtors, developers, both foreign and domestic. • Work closely with team bankers and lawyers to determine applicability of proposed approaches. 	

Team

Foreign:

- Kevin O'Brien (FT)--
Procedures/Docs.
- TBD Banker (PT)--
Procedures/Docs.
- TBD (PT)--Training
- Linda Leimenstoll (FT)--
Assistance

Local:

- Russian Assistant (FT)

- TBD (PT) foreign lawyer.
- TBD (PT) Russian lawyer,
organized and overseen by the
foreign lawyer.

- Richard Lloyd, Investment
Banker/Corporate Finance
Specialist (PT).

- Identified as needed.

II. Summary Workplan

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