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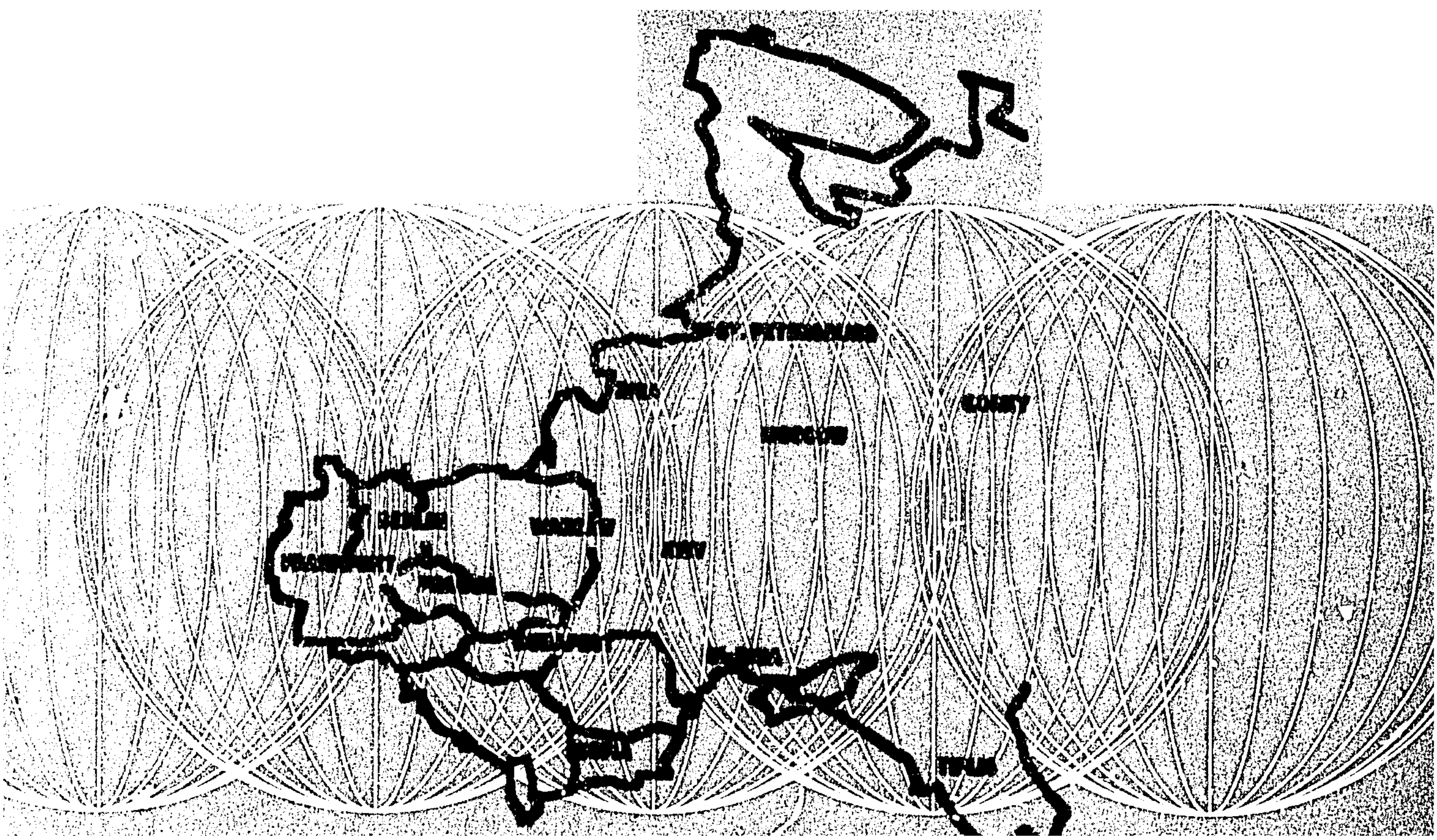

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HOUSING FINANCE IN RUSSIA
DEVELOPMENTS IN 1992

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ABSTRACT

In March 1992 the United States Agency for International Development signed Memoranda of Understanding with the Russian Federation government and three Russian cities to assist the federal and city governments in reforming the shelter sector. Under the auspices of this program, the Urban Institute was consulted to provide technical assistance to the Russian Federation and Moscow city governments. The major goal of the reform effort is to reorient the shelter sector along market principles. Reforming the housing finance system is a critical element in reforming the housing sector and the national economy in Russia.

This report discusses the steps the Russian Federation took in 1992 to address some of the fundamental problems present in the previously existing system of long-term housing lending. The paper summarizes the state of long-term housing lending before the transition period that began in 1991 and then discusses the actions taken by various branches of the federal government and banking community to reform the housing finance sector. The paper concludes with an assessmment of these actions and recommendations for future reform.

EXECUTIVE SUMMARY

The housing situation in Russia is legend for its shortages. The situation has worsened as the country has experienced the current period of economic transition. Housing construction has declined steadily in recent years. Further declines are likely because funds for housing have been largely eliminated from the central budget as the federal government attempts to decentralize its control over the housing industry. Local governments do not possess the revenues to replace the funds lost to decentralization efforts. Surging inflation during 1992 wiped out the savings of many households. The result of these combined factors is that only a small share of families possesses the financial means to purchase a unit without a loan.

Long-term mortgage lending will increase the effective demand for new construction and thus help alleviate housing shortages in Russian. However, expanding long-term housing lending in Russia is a challenging task in a climate characterized by little precedent in housing lending, an embryonic and poorly supervised banking system, and a highly volatile economy. Nonetheless, progress in being made in strengthening and legitimizing the housing lending system.

A. *Traditional Housing Lending*

Traditional long-term housing lending in Russia was simple and characterized by the following attributes:

- Loan volume each year was determined in the centrally-developed economic plan.

- Lending was for individual construction and housing cooperatives. Most lending took place in small cities and rural areas because individual construction was forbidden in cities over 100,000.

- Housing loans were not explicitly secured by the property as collateral and the lender's ability of to evict defaulted borrowers uncertain. Lenders circumvented this risk of delinquency by having employers directly deduct payments from wages.

- The loan instrument was a fixed rate loan; interest rates were low and loan periods long.

Mortgage lending in Russia has been low compared even with other countries that formerly had centrally-planned economies, like Poland and Hungary. Russia has an extremely low ratio of mortgage loans to total housing investment - primarily attributable to the enormous role played by direct state investment in the production of new rental housing.

After 1989 loan volumes for individual construction began to outnumber loans for housing cooperatives. In 1988 and 1989 loan volumes to the two types of borrowers were about the same. The shift appears to be attributable to the elimination on the moratorium on individual house construction in cities over 100,00 and a pent up demand for low density housing.

B. Developments in 1992

In 1992 the government and private banking community pursued concrete steps to establish the foundation for real mortgage lending. At the same time the government began the questionable policy of subsidizing housing lending.

Government Action

Legal Developments. Although the legal framework for mortgage lending requires additional development, several laws and Presidential decrees adopted in 1992 are noteworthy. Collateralized lending in general is addressed by the Law on Collateral passed by the Supreme Soviet in May 1992. Supplemented by existing laws (the Land Code and Code of Civil Procedure) the Law on Collateral offers what many Western lawyers who have reviewed the law believe is a serviceable basis for mortgage lending.

The Law on Collateral may be strengthened by careful crafting of the implementing regulations. However, even after the necessary regulations are issued, two major problems exist that may prohibit effective implementation of the Law. First, it is unclear how the courts will address the issue of foreclosure and eviction. The Housing Code which forbids eviction from state housing without the provision of alternative housing is not fully supported by other laws which allow foreclosure and eviction. Second, no effective and comprehensive system of property registration exists despite laws passed by the Supreme Soviet two years ago mandating the creation of such a registration system. Without this system, lenders may face very substantial uncertainty about the ownership of properties and land proposed as collateral.

Bad Habits. In the first half of 1992, the Government addressed the problem of reduced purchasing power by would-be purchasers of new residential units through subsidies combined with continued use of the fixed rate mortgage. The goal of these initiatives was to maintain housing affordability. However, with few restrictions on program eligibility, those who benefit from these programs are often not those most in need of affordable housing. Another concern, beyond the economic wisdom of government subsidies for homepurchase, is that such government actions indicate that the the government is responding to pressure by well-connected groups or by its own agencies (e.g., Sberbank) in making its funding decisions rather than having a thought-out strategy of its own.

Private Initiatives

Given the extraordinarily difficult conditions for long-term mortgage lending in Russia in 1992, bankers displayed a surprising interest in exploring the possibility of such lending. Several new institutions with "mortgage bank" in their names have been created. Two investigated for this report were the St. Petersburg Mortgage Bank and the Joint Stock Mortgage Bank of Moscow. Currently, both are primarily engaged in commercial transactions. However, both banks have future plans to expand their role in the shelter sector.

C. *Plans for the Future*

Beyond the actual developments in 1992, several banks have prepared concrete plans for realization of mortgage lending.

Contract Savings at Sberbank

Sberbank proposes to establish a subsidiary which would engage in long-term housing lending using the savings of future borrowers as the source of funds. The system would be a "closed system" patterned on the Bausparkassen systems of Germany and Austria. The scheme relies on a series of subsidies during the savings period to maintain the real value of saving and potentially large interest rate subsidies during the borrowing period. An analysis completed of the program concludes that the program would provide savers a large measure of protection against inflation, but the cost of doing so is high. Furthermore, enterprises as well as the state will be required to bear this burden. Given this precarious financial condition of many firms, it appears ill-advised to further handicap them with mandatory subsidies to employees as the Central Bank scheme envisions.

Mortgage Standard Bank and Mosbusinessbank

Both of these banks are in the process of organizing themselves to begin long-term housing lending. The Mortgage Standard Bank, with Sberbank and Industrial Commercial AvtoVAZbank as its principal equity holders, plans to begin lending as soon as it becomes operational. This should occur before the end of 1993. Mobusinessbank (MBB) is receiving substantial assistance from USAID in the creation of lending operations. MBB's target date to begin lending is January 1994.

D. *Making Mortgage Lending Feasible: Reducing and Allocating Risk Efficiently*

Making long-term mortgage loans in Russia involves taking even greater risks than those normally associated with lending in countries were there is a well-developed housing finance system. These risks may be mitigated by appropriate regulatory action from the federal government and proper internal operating practices within the lender institution.

Possible Actions to Reduce Risk

To reduce the *credit risk* -- the risk that the borrower will not repay the loan-- the government could:

- establish the ability for the lender to foreclose; create an expedited system in the courts for hearing cases concerning default on a housing loan.

- establish mortgage insurance on a commercially sound basis; the lender should retain a significant share of the risk of loss in case of default to encourage careful loan underwriting.

- establish a reliable registration system for land, property, and mortgage and other liens on land and property to reduce lenders' risk from clouded titles.

To reduce the *interest rate risk* -- the risk that the cost of funds to the lender will rise to a greater extent than the interest rate on outstanding loans, thereby causing him to lose money on the loans -- the government could:

- grant affirmative permission and encourage use of indexed mortgage instruments that are suitable to inflation prone economies.

- grant affirmative permission and encourage use of liabilities with indexing structures identical to those for mortgages.

- develop reliable indexes for use with these instruments, indexes in which the public will have confidence.

To lessen the *intermediation/liquidity risk* -- risk that the lending institution will not have funds available to depositors or other liability-holders -- banks could:

- encourage State Pension Fund and other government funds to purchase mortgage-backed securities at market prices.

- establish an emergency liquidity facility, with funds available at market interest rates.

- establish a liquidity facility for purchase of a share of the negative amortization on indexed mortgage instruments (e.g., PLAMs and DIMs) at market interest rates.

As of the publication of this report many of these concepts are currently being considered by the appropriate actors in the Russian government and banking community. To date, however, no concrete action has been taken to implement any of these concepts.

D. Conclusions

It is very difficult to forecast the future state of the mortgage financing system in the Russian Federation. Much depends upon the actions taken by the federal government to arrest the escalating rate of inflation and establish the broad financial and legal conditions for mortgage lending that will protect both lender and borrower. In the current precarious legal and economic climate it is encouraging to see banks are ready to begin long-term mortgage lending. Although the methods chosen to implement the lending system (fixed rate interests and direct government subsidies) may be criticized, it is encouraging to see that there exists in government the presence individuals who understand what needs to be done. Converting this conceptual strength into action will take some time, but some real action may be seen in 1993.

HOUSING FINANCE IN RUSSIA: DEVELOPMENTS IN 1992

Readily available housing finance is a critical element in the reform of the housing sector and the national economy in Russia. Housing investment has traditionally been an important component of capital investment: in 1990 housing constituted 15 percent of total investment. During the period of economic transition, housing investment has been down sharply: the completion of housing (measured in square meters--the standard measure in the USSR) in 1991 was down 32 percent from 1989; and in 1992 production is forecast to be about 35 percent of the 1989 level.[1] Further reductions are in prospect because housing has been largely eliminated from the central budget, the former primary source of state investment; local governments are not able to replace these funds because of their own budgetary difficulties. Similarly, many enterprises are cutting their orders for new housing in response to the economic slump.

The housing situation in Russia is legend for its shortages. The better estimates suggest that 40 percent of households in urban areas are living in overcrowded conditions (Kosareva, 1992). While some of this shortfall could be met by a more efficient allocation of the available stock, massive shortages would still remain.[2]

At the same time surging inflation during 1992 wiped out the savings of many households who have been unable to find savings instruments to preserve the value of their wealth (CIS Statistics Committee, 1992, Table 5). Hence, only a small share of families have the ability to purchase a unit without a loan. Free- or nearly-free-of-charge-privatization of state rental housing is increasing the number of families who could generate a large downpayment through sale of their newly acquired unit; but most of them would also likely need a loan to purchase a new unit.[3]

Under these conditions increasing the effective demand for new construction through long-term mortgage lending is clearly necessary. Additionally, spurring the demand for housing would help reduce the money balances in circulation.

[1] Estimate is a simple forward projection of results for the first nine months to the balance of the year. Data on production levels are from Goskomstat.

[2] Struyk et al. (1992) estimate that about 45 percent of the renter households in Moscow occupied more square meters of housing than a reasonable social norm. Such "over consumption" is expected where rents are extremely low and there is no incentive for households to shift to smaller units when household size declines.

[3] Through October 1992 about 1.5 million state rental units had been privatized under the 1991 privatization act, or about 5 percent of the state stock in urban areas. See Kosareva and Struyk (forthcoming) for a description of this program.

Consumers are now using these balances to chase the limited supply of goods which can act as a store of wealth.

Expanding long-term housing lending in Russia is a challenging task. The situation can be characterized simply as follows:

- While there has been limited lending for housing, lending in which the housing asset serves formally as collateral has not existed;

- The banking system is embryonic and the creation of over 1,500 new commercial banks in the past two years has resulted in a poorly supervised and probably fragile system;[4]

- High and volatile inflation rates imply potentially great interest rate risk for long-term lending, since the banking system's liabilities are heavily concentrated in short-term accounts;[5]

- There is potentially grave credit risk associated with housing lending because the current confusion about the legal basis for eviction of an occupant from his unit.

This paper discusses the steps that the Russian Federation took in 1992 to address the fundamental problems of long-term housing (or mortgage) lending implied in the previous paragraph. It begins with a brief overview of long-term housing lending as it existed at the beginning of the transition period, which we mark for convenience as the beginning of 1992. The second section describes the actions taken by both the Government of Russia and the Supreme Soviet of the Russian Federation and the initiatives of individual lenders. The third section reports on the concrete plans of several banks. The forth section assesses the actions of governments and lenders from the perspective of their impact on reducing the various types of risk which lenders face in making long-term housing loans. The final section provides some brief conclusions.

A. *Traditional Housing Lending*

Traditional long-term housing lending was quite simple and can be characterized by the following four points:

[4] International Monetary Fund et al. (1991), vol. 2, Chapter IV.5.

[5] After inflation averaged 100 percent per month for the first four months, it was only 7 percent for the month of July. However, further shocks were expected because of the Government's decision to increase energy prices and the sharp expansion in the money supply by the Central Bank to support failing enterprises.

(1) Loan volume each year was determined in the centrally-developed economic plan. Beginning in 1988 all long-term housing lending was done by the State Savings Bank, also known as Sberbank.[6]

(2) Lending was for individual construction and housing cooperatives.[7] Since 1961 individual construction has been forbidden in cities of over 100,000 population; only cooperative loans occurred in these places. Individual loans were concentrated in smaller cities and rural areas.[8]

(3) Housing loans were not explicitly secured by the property as collateral and eviction was questionable. In practice, lenders protected themselves by typically having loan payments deducted from wages by employers; where this was not possible, guarantors were sought and the bank could have wages garnished for non payment. Under this regime Sberbank experienced low levels of delinquencies.[9]

(4) The loan instrument is a fixed rate loan; interest rates were low and loan periods long.

Basic information on the lending of the past few years is given in Tables 1 and 2. We focus here on events through 1991; developments in 1992 are discussed in the next section. The data in Table 1 show that loans to individuals can be characterized as having extraordinarily long terms and carrying very low interest rates. These loans carried subsidies: the 2 percent interest rate charged until 1991 was less than the bank's cost of one-year time deposits and only 100 basis points

[6] Before this loans to individuals were made by Gosbank and Stroibank. Loans to members of cooperatives were made by Zhilost Bank and Stroibank.

[7] There are two types of cooperatives: housing building cooperative (HBC) and housing cooperatives (HC). For HBCs the borrower is the cooperative which on-lends to individual households. For HCs individual members obtain loans to purchase the units from a seller--municipal government or an enterprise. See Andrusz (1991) for a thorough discussion of housing cooperatives in the USSR.

[8] In reality, housing cooperatives were highly concentrated in Moscow and St. Petersburg.

[9] As of the end of 1991, Sberbank's cumulative delinquent payments were rub 6.4 million on a housing loan volume of rub 10 billion. Source: interview with M.A. Gavrilin and A.K. Abramova, August 12, 1992.

Table 1
Housing Loan Terms in the Russian Federation
1988-1992

	1988	1989	1990	1991	1992 (9 mo)
Loans to individuals[e]					
Interest rate	2	2	2	3	8(+12)[a]
Loan term (years)	50	50	50	25	20
Maximum LTV	75	75	75	75	75
Maximum loan (th. rub.)	20	20	20	20	--
Loans to cooperatives (HBC)[d]					
Interest rate	.5	.5	.5	3	8(+12)[a]
Loan term (years)	25	25	25	25	20
Maximum LTV[b]	70	70	70	70	70
GDP deflator, 1988=100	100	103	106	233	2990
Interest on 1-year time deposit (%)	3	3	3	5	30[c]

Notes:
a. Since April 1, 1992 individual or cooperatives pay 8% and 12%; loans are subsidized by the state budget. For the period January 10 to April 1, 1992 the interest rate on loans to individuals was 15%.

b. LTV was determined through special decrees of the Soviet government. Some regions, e.g., Siberian coal areas, had and still have LTVs of 80%.

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

d. House Building Cooperative.

e. Loans for construction of individual houses.

Source: Sberbank.

above the official inflation rate. In 1991, the loan rate was 200 basis points below the one-year time deposit rate. Maximum loan amounts were reasonable compared with the cost of housing.

Lending for units constructed for Housing Building Cooperatives (HBC) carried deeper interest rate subsidies--the interest rate on these loans being only .5 percent. The loan term was shorter than on individual loans, but at 25 years still long enough to permit low monthly payments.

Even in 1990, loan interest rates were negative in real terms. By 1991 they were sharply negative, setting the stage for even worse conditions in 1992.

As shown in Table 2, the good news for Sberbank is that its volume of long term lending for housing has been small, and in recent years it has fallen in real terms. There are several ways to make the point about small loan volume. In 1991, the *number* of loans to individuals was the equivalent to about 0.2 percent of the 1990 housing stock, and 0.8 percent of the 1990 single family housing stock.[10] Similarly, such lending constituted only 0.2 to 0.4 percent of national income.

There is no question that housing lending in the Russian Federation has been low compared with other countries. The figures in Table 3 document that among middle-income countries the Russian Federation had an extremely low ratio of mortgage loans to total housing investment. This, of course, is largely attributable to the enormous role played by direct state investment in the production of new rental housing. But even compared with Poland and Hungary the Russian figure is tiny.

[10] Data on the 1990 stock are from the State Committee on Statistics of the RSFSR (1991).

Table 2
Long-Term Lending for Housing in the Russian Federation: 1988-1992

	1988	1989	1990	1991	1992 (9 mo)
Loans to individuals[c]					
Number (thousands)	73.4	53.1	124.4	94.8	c
Volume[a]	661	438	1,296	2,127	10,138
Average loan size[b]	8.9	8.2	10.4	22.4	c
Loans to cooperatives					
Volume[a]	574	502	468	648	1,293
Total volume[a]					
Current prices	1,235	940	1,763	2,775	11,431
1988 prices	1,235	912	1,682	1,191	382
Ratio of loan volume to GDP	0.32	0.16	0.28	0.23	0.14

Notes: a. Millions of rubles, current prices
b. Thousands of rubles, current prices
c. Data not available

Source: Sberbank

Within the low aggregate volume of lending, there has been a notable shift in the composition of loans between those for individual construction and for cooperatives. In 1988 and 1989 loan volumes to the two types of borrowers were about the same, but thereafter volumes shifted sharply in favor of individual construction. This change appears to be attributable to two factors: the prohibition against individual construction was eliminated in 1987 and there was substantial response driven by pent up demand for low density housing; and, as construction costs began to rise many of the middle income families on the waiting lists for cooperatives found it would be difficult to make the higher loan payments, and this caused a reduction in new starts (loans to cooperatives are made at the beginning of the construction period).

Table 3
Ratio of Mortgage Loans for Housing to Total Investment for Housing: Selected Middle Income Countries[a]

Eastern Europe					
Poland	.33	Jamaica	.28	Brazil	.21
Hungary	.41	Korea	.62	Chile	.44
Russian Fed.[b]	.07	Colombia	.60	Jordan	.34
		Malaysia	.73	Philippines	.58
Other		Mexico	.77	Tunisia	.20
Thailand	.66	Turkey	.07	Venezuela	.24
Morocco	.25				

Notes: a. Data are generally for 1990.
b. Long-term housing loans, not mortgages.

Source: World Bank Housing Indicators Project and author's calculations for the Russian Federation.

B. *Developments in 1992*

The Russian government--including Sberbank--took several steps in 1992 to establish the foundation for real mortgage lending, though it also began subsidizing housing lending in highly undesirable ways. At the same time there were notable developments in the private banking community. This section covers the major governmental developments and provides highlights of the private initiatives.

Government Actions

Legal Developments. Some elements of the laws passed and Presidential Decrees issued will have some immediate impact, but most are elements of a system that still requires additional development.

A very important development was the passage in May by the Supreme Soviet of the Law on Collateral. While addressing collateralized lending in general, it includes property and land among the items that can serve as collateral. More specifically, land is included only if there is a mortgageable structure on it; otherwise land mortgages are still governed by the RSFSR Land Code. The Law on Collateral also permits the mortgaging of land rights with the consent of the owner--an important feature in Russia where sales of municipally-owned land in urban areas has been highly restricted and most land has been conveyed through leasehold. The amendment to Article 12 of the Constitution by the Seventh Congress of Peoples Deputies will likely make clear ownership of residential land much more common.[11]

The Law on Collateral makes clear the power of the mortgagee to sell the collateral securing the loan to satisfy his just claims, and the procedures for foreclosure are specified in the Code of Civil Procedures (Butler, 1992a). These provisions for mortgage lending are being refined in a new law that is being drafted by the germane committee of the Supreme Soviet.

Western lawyers who have reviewed the law believe that it offers a serviceable basis for mortgage lending. They also believe that the law could be significantly strengthened by careful crafting of the implementing regulations (Butler, 1992). Two major problems exist with respect to the implementation of the law's provisions after the necessary regulations are issued. First, the housing code, based on constitutional provisions, forbids eviction of households from state rental dwelling units without the provision of comparable substitute housing.[12] When a foreclosure is presented to the courts it is not certain how the courts will react, despite the fact that the Law on Collateral and the Civil Code both explicitly allow foreclosure and, if necessary, eviction (Butler, 1992a).

Second, registration of land, properties, and mortgages may pose a problem--at least in the short-term. Laws passed by the Supreme Soviet in the past two years on land and property mandate the creation of the necessary registration systems.[13] Administrative decrees mandate the creation of reliable cadastre, and the draft mortgage law requires that mortgages be registered in the land register maintained by local governments.[14] However, the regulations implementing the registration systems have not been promulgated by the Council of Ministers. Until registration is in effect, at least outside of the cities, lenders may face very substantial uncertainty about the ownership of properties and land proposed as collateral. On the other hand, it must be noted that some cities, including Moscow, have moved

[11] The applicability of the revised Article 12 is unsettled at this time. Some lawyers are arguing that it applies only to rural land; others take the position that it applies to urban land.

[12] Actually, under some very extreme conditions, eviction without substitute housing is permitted.

[13] The legal concept of residential real estate was introduced through the city planning law in mid-1992. This concept was strengthened by the passage of the basic housing reform law, "On the Fundamentals of Housing Policy in the Russian Federation," which was passed only on December 24, 1992.

[14] Enactment No. 622, "On Perfection of Management of the State Land Cadastre in the Russian Federation," issued by the Premier of the Russian Federation, August 25, 1992.

fairly aggressively to implement registration systems; and some cities have already issued local regulations requiring the registration of mortgages.

Bad Habits. In the first half of 1992, the Government displayed a distinct tendency to address the problem of reduced purchasing power by would-be purchasers of new residential units through subsidies combined with continued use of the fixed rate mortgage. The subsidies were believed necessary to offset increases in house prices and interest rates associated with inflation; subsidies were to help sustain housing affordability. As far as we can determine, limited, if any, analysis of the full cost of such subsidies was made prior to the decision to implement the programs.

Two cases illustrate this proclivity on the part of Government. First, under Presidential Decree 140 households purchasing a unit through a housing cooperative which began construction before January 1992 receive grants covering 70 percent of the increase in unit costs and interest rate increases. The subsidies are shared equally between the Federation and lower levels of government. Second, under an agreement among the Ministry of Finance, the Central Bank, and Sberbank effective April 1, 1992, Sberbank committed to lending 20 percent of deposits for farm development and individual and cooperative housing at a 20 percent interest rate. Of the 20 percent, only 8 percent is paid by the borrower and 12 percent is paid from the Federation budget.[15]

In neither of the two programs just described are there income, unit size, or other restrictions on eligibility. Indeed, a rich Muscovite who had received a free-of-charge unit through privatization would qualify for the loans being made by Sberbank.

A real concern about these governmental actions, beyond the inefficiency of the programs, is that they indicate that the government is responding to pressure by well-connected groups or by its own agencies (e.g., Sberbank) in making its funding decisions rather than having a thought-out strategy of its own. The World Bank (1992, p.77), in the context of subsidies for Russian industry, has observed the following problems with such an approach, which apply in this context as well:

(1) Discretionary and bargained granting of new subsidies is bad for economic stabilization to the extent that it worsens fiscal and financial deficits.

(2) This type of relationship between government and industry clearly works in favor of existing producers and their owners and managers.

[15] Because Sberbank's average cost of funds in about 13 percent, even these loans which carry extremely negative real interest rates are profitable for the bank.

(3) Such policies tend to reinforce old patterns of influence-peddling and lobbying.

(4) It presents the government with an acute dilemma of how to encourage and support the recovery of production without finding itself locked into underwriting the demands of a still unreconstructed industrial elite, thereby perpetuating the dependent rather than encouraging the entrepreneurial.

Private Initiatives

Given the extraordinarily difficult conditions for long-term mortgage lending in Russia in 1992, bankers displayed a surprising interest in exploring the possibility of such lending. Indeed, several new institutions with "mortgage bank" in their names have been created. Despite these hopeful signs, we are aware of no long-term lending for housing besides that done by Sberbank.

New Mortgage Banks. An unknown number of "mortgages banks" were registered in the Russian Federation in 1992. Here we report on two banks that we investigated, one in Moscow and one in St. Petersburg.

The *St. Petersburg Mortgage Bank* was selected because it had received a good deal of attention from the press.[16] The bank, established in February 1992, has five founders which include a commercial bank, a government agency, and three enterprises, including a joint venture between Russian and British firms. Together they have paid in something over one-half of the rub 100 million authorized capital. As of the end of November it had not made any long-term loans, nor has it made loans yet to individuals for home purchase. Reasons cited for this reluctance to lend included problems with the eviction of borrowers in case of foreclosure and the high duties for notarizing property transfers. It has, however, made two short-term commercial loans in which a property explicitly serves as collateral.

The bank's main housing-related activity is organizing the purchase of units in inner-city buildings now containing communal flats. Purchasers of the units in the to-be-rehabilitated building make payment to the bank in advance for their unit. The bank helps obtain rights to the property, assists in arranging for sitting tenants to be relocated to new flats, and provides a construction period loan for the rehabilitation of the property.

It appears that the bank's principal form of funds mobilization is through a retail savings deposits program. Savers place deposits for 7 to 13 months; they are paid a 10 percent interest rate if the deposit term is at least one year. Deposits are

[16] This description is based on material developed by Olga Kaganova in a meeting with the president of the bank, Mr. A. Vorobyev, and various written documents provided to her by Mr. Vorobyev. Not as much detailed information was obtained as desired, but Mr. Vorobyev cited "commercial secrets" as the basis of his reluctance to give additional details.

in increments of rub 50,000, up to rub 150,000. The main incentive to savers is a lottery each six months, with the lottery winner being awarded an apartment. One apartment is awarded for each 100 savers. Savers with larger deposits receive a larger apartment, e.g., those saving rub 150,000 receive a three-room apartment. While the St. Petersburg Mortgage Bank is conducting some interesting activities, it not engaging in mortgage lending as conventionally defined.

The *Joint-Stock Mortgage Bank*, located in Moscow, was registered only on December 24, 1992 and began operations in January 1993. It principal share holders are five commercial banks, and other founders include an insurance company and Moscow commercial firms.[17] Paid-in capital is sufficient to place the bank among the top 15 percent of banks, measured by paid-in capital. The bank will concentrate initially on commercial loans, some of which will be secured by real estate (and, therefore, will be labeled "mortgage loans"). The bank has a strong interest in originating long-term mortgage loans but no immediate plans to begin such operations. Funds mobilization plans were under development at this writing.

C. *Plans for the Future*

Beyond the actual developments in 1992, several banks have prepared concrete plans for the realization of mortgage lending. This section briefly describes some of these.

Contract Savings at Sberbank

Sberbank proposes to establish a subsidiary which would engage in long-term housing lending using the savings of future borrowers as the source of funds. The system would be a "closed system" patterned on the Bausparkassen systems of Germany and Austria. The principal difference between the Austro-German system and the one proposed for Russia is caused by the inflationary environment in which the Russian scheme would operate. The scheme designed by Sberbank is complicated, relying on a series of subsidies during the savings period to maintain the real value of the savings and potentially large interest rate subsidies during the borrowing period. The main benefit of the system is that it would mobilize household funds for use in the housing sector; from a macro-economic perspective anything that increases the savings rate is clearly helpful.

A recent analysis has computed the present value of the subsidies involved in this scheme (Ravicz, 1992).[18] The primary assumptions underlying the analysis are as follows. Families can devote 25 percent of their income to savings and 25 percent

[17] Information based on interview with Arkay Ivanov, President of the bank.

[18] Note that the scheme described is as it was proposed in November 1992. It may have changed in the meantime.

of their income to mortgage payments. Employers are required to make an annual contribution of 10 monthly minimum wages to savers' accounts. These funds are tax-exempt for the enterprise and for the saver. Families' own contributions to savings and interest earned on savings are also tax-exempt. However, the total state revenues foregone from tax exemptions for family savings and interest income are subject to a maximum yearly cap of 10 monthly minimum wages. The tax rate for enterprises is 35 percent; and for borrowers it is 12 percent for those with monthly incomes of rub 20,000 and 40 percent for those with monthly incomes of rub 100,000.

To adjust for the effects of inflation, the assumptions and findings were expressed in constant, November 1992 rubles. It assumes that both participants' incomes and the monthly minimum wage increase with inflation. The monthly minimum wage is assumed to be rub 1,500 in constant terms.

Interest paid to depositors is set on a sliding scale depending on the length of the contracted savings period: at about 96 percent of the Central Bank base rate for families who save for 8 years and 81 percent of the base rate for those who save for 2 years. For these calculations Ravicz assumed that one-half of the volume of deposits are for 2 years and one-half are for 8 years.

Loan terms also depend on the length of the savings period. Families who save for 2 years can take out a 10-year variable rate loan for a maximum amount equal to their accumulated savings, or one with initial payments not exceeding 25 percent of their income, whichever is less. Eight year savers are subject to the same restrictions with the exception that their loan term is 20 years.

The interest rate on the loan is set at the Central Bank base rate. Of this total amount, families pay a portion, and the government pays the rest. The interest paid by borrowers is detailed in Table 4. As the table indicates, as the Central Bank base rate declines the borrower's share of interest payments increases. When the central bank rate is 11 percent or below, there is no government interest rate subsidy. Interest rates are higher for 2-year savers than for 8-year savers.

Table 4
Interest Rates for Borrowers and the State
Under Alternative Central Bank Base Interest Rates

Central Bank Base Interest Rate	Borrower Interest Rate	
	If Saved 2 Years	If Saved 8 Years
51% or Greater	22%	19%
26% to 50%	17%	14%
11% to 25%	12%	9%
Below 11%	Central Bank Rate	Central Bank Rate

Ravicz examined the contract savings program for one participant with a monthly income of rub 20,000 and one with a monthly income of rub 100,000. The savings period is for either 2 or 8 years. Outcomes were considered under two inflation scenarios. Under the high inflation scenario, inflation is 300 percent in the first year of the contract savings program, and declines slowly to 10 percent by year 10. The central bank base rate is negative in real terms until year 7. In the low inflation scenario, inflation is 100 percent in the first year, and declines to 10 percent by year 5. The central bank base rate becomes positive in real terms by year 2.

Ravicz concludes that the program would provide savers a large measure of protection against inflation, but the cost of doing so is high. The subsidy as a share of savings would range from 41 to 60 percent for a family with an income of rub 20,000. The family's subsidy as a share of its combined savings plus loan would drop somewhat to 24 to 54 percent. Nevertheless, a family with this income would still only be able to afford about 60 percent of the cost of a modest unit at the end of 8 years if they could afford to devote 25 percent of their income to savings and mortgage payments.

A family with a rub 100,000 income will have less protection against inflation and smaller ratio of subsidy to savings and subsidy to loan. This higher income family will have a combined subsidy to total savings plus loan ratio of from 6 to 33 percent. Nevertheless, the subsidies to this family will be much larger in absolute terms than the subsidies to the lower income family. This family will be able to afford from 230 to 298 percent of the cost of a modest unit at the end of an 8 year savings period.

In sum, Ravicz concludes that the subsidies are high and not well targeted. Furthermore, enterprises as well as the state will be required to bear this burden. Given the precarious financial condition of many firms, it appears ill-advised to further handicap them with mandatory subsidies to employees.

Mortgage Standard Bank

Sberbank has been active in the creation of another new mortgage bank --the Mortgage Standard Bank. The bank was in the process of being registered at the beginning of 1993, with its principal equity holders being Sberbank and Industrial Commercial AvtoVAZbank. Total paid-in capital from these and other founders is rub 200 million. The parent banks would be the main source of funds, at least for the first two years. Plans are for the mortgage bank to begin long-term housing lending as soon as it becomes operational. In the first phase of such lending, loans will be made to employees of enterprises which establish a special relationship with the bank; this relationship will extend both to the enterprise keeping some funds on deposit and to working with the bank to structure lending programs that are affordable to its employees and entail a low credit risk to the bank. The bank plans to use some form of an indexed mortgage instrument for its lending.

Mosbusinessbank

In December Mosbusinessbank (MBB), one of the largest and financially strongest commercial banks, announced that it would begin mortgage lending, possibly through the formation of a subsidiary mortgage bank. Included in the announcement was the conclusion of an agreement with the U.S. Agency for International Development under which MBB will receive substantial assistance with the creation of lending operations during 1993. Macroeconomic conditions permitting, the target date for beginning lending is January 1994.

D. *Making Mortgage Lending Feasible: Reducing and Allocating Risk Efficiently*

In general, making long-term mortgage loans involves several risks. In Russia, with its volatile economic conditions and the questions surrounding eviction and foreclosure, the risks are increased. These risks can be reduced significantly--and at low cost--by appropriate action by the national government.[19] Additionally, lenders have the ability to mitigate some of these risks, particularly interest rate and credit risks, through adoption of proper practices. This section begins by discussing the various types of risk and how government could help address them. It then looks at the actions that government and banks have taken to date in this sphere.

Possible Actions to Reduce Risk

Specific actions that could be taken by government include the following:

Credit risk -- the risk that the borrower will not repay the loan.

[19] This section draw heavily on Struyk and Kosareva (1992).

- establish the ability for the lender to foreclose; create an expedited system in the courts for hearing cases concerning default on a housing loan.

Clearly, the necessity for the ability to foreclose a loan and evict the borrower in default is fundamental to collateralized lending. A special system of courts will help insure that foreclosure is a reality. Until the constitution of the Russian Federation is appropriately amended, government can determine the types of lending procedures that have been effective in other countries in which foreclosure is difficult or impossible but lenders have successfully dealt with credit risk; India is a prominent example.[20]

- Establish mortgage insurance on a commercially sound basis; the lender should retain a significant share of the risk of loss in case of default to encourage careful loan underwriting.[21] Note that banks with poorly defined mortgage loan underwriting procedures would not receive such insurance and that banks with high rates of loan defaults would not be permitted to insure loans in the future.

- Establish a reliable registration system for land, property, and mortgage and other liens on land and property to reduce lenders' risk from clouded titles.

Interest rate risk -- the risk that the cost of funds to the lender will rise to a greater extent than the interest rate on outstanding loans, thereby causing him to lose money on the loans.

[20] A description of the procedures followed by the most successful Indian mortgage lender is in Buckley et al. (1985).

[21] The coverage provided by mortgage insurers is generally of the form that the insurance company will pay the loss associated with a mortgage loan default up to 20 to 30 percent of the outstanding loan balance at the time of the default. The loss in such cases is computed as the difference between the price at which the unit is sold at auction (after the loan has been foreclosed and the owner/borrower has been evicted), on the one hand, and the amount of the outstanding mortgage loan balance and various costs associated with foreclosure and sale, on the other hand.

In the Russian context, this formulation may not be appropriate as the standard procedure assumes that foreclosure and repossession of the property can be achieved quickly. Because of constitutional provisions, this is not now the case in Russia. Therefore, another formulation will be superior. Under this arrangement, when the borrower stops making payments, the insurance company will begin making quarterly payments to the bank. These payments will be for one-half of the payment the borrower should have made. They will continue until the total payments equal the same 20-30 percent of the outstanding loan balance as under the conventional arrangement. The insurer only pays one-half of the full payment in order to keep a strong incentive for the bank to try to make collections or foreclose the loan. Should the property eventually be acquired and the property sold, the insurer will receive a proportional share of the net proceeds from the sale.

- Grant affirmative permission and encourage use of indexed mortgage instruments that are suitable to inflation prone economies.

The Price-Level Adjusted Mortgage (PLAM), the Dual Index Mortgage (DIM), the Bulgarian Indexed Capped Credit (BICC) and similar loan instrument designs were developed to work in countries with high or volatile inflation. They increase the size of the loan the borrower can take with a specified share of his income by lowering the interest rate to around 5 percent; the full interest rate payments are captured later because the loan principal is indexed to inflation or a cost-of-funds index. Thus these instruments shift some of the increased interest payments required on the loan when interest rates rise into the future when the borrower will better be able to pay them because his income will be higher. Equally important, these instruments shift most or all of the interest rate risk away the lender to the borrower.[22]

- Grant affirmative permission and encourage use of liabilities with indexing structures identical to those for mortgages.

- Develop reliable indexes for use with these instruments, indexes in which the public will have confidence.

Intermediation/liquidity risk -- risk that the lending institution will not have funds available to depositors or other liability-holders.

- Encourage State Pension Fund and other government funds to purchase mortgage-backed securities at market prices.

Pension funds and insurance companies typically have a large volume of investable funds. In addition, their needs for cash can be quite accurately predicted on a year-to-year basis. For this reason they have a comparative advantage in making long-term investments. Mortgages are clearly such an investment. At the same time, there are few good investment instruments in Russian financial markets. Price or interest rate-indexed bonds or other securities based on pools of mortgages should, therefore, be a highly attractive investment. A good policy could be to give pension funds and insurance companies a target for their holding of mortgage investment, perhaps to reach 5 percent of investments over a two- or three-year period.

- Establish an emergency liquidity facility, with funds available at market interest rates.

[22] These instruments are described in detail in Telgarsky and Mark (1991) and Ravicz (1992a).

The Central Bank does not now stand ready to act as an emergency liquidity facility for banks. This is not to say that the Central Bank should be obligated to provide funds "on demand" from banks in difficulty. Rather, it should be obligated to move quickly to review a bank's request for short-term funding assistance and act expeditiously to provide it when a decision is made to do so.

- Establish a liquidity facility for purchase of a share of the negative amortization on indexed mortgage instruments (e.g., PLAMs and DIMs) at market interest rates.

A characteristic of the indexed loans is that they defer some of the payments due early in the life of the loan to later years when the borrower, whose income will have risen, will be in a better position to make the larger payments. Because of the deferral of the payments, the loan balance increases. The deferred payments mean that in the early years of the loan the bank has less funds with which to pay interest on deposits and to make payments to those who want to withdraw their deposits. Hence, it could experience some liquidity difficulty. Such difficulties will only occur, however, to banks that are holding a sizable share (over 30 percent) of its assets in these types of loans.

Under this proposal the Central Bank would establish a facility that would consider requests from banks originating indexed mortgage loans for the facility to purchase the securities explicitly collateralized by these mortgages. In this way major mortgage lenders would have resolve their liquidity problem. The facility would base its decision to purchase the mortgage-backed securities offered to it in part on the share of all assets constituted by the indexed mortgages.[23]

It would be desirable for macroeconomic policy for the facility not to purchase these funds exclusively with Central Bank funds. The expansion in the supply of money could be controlled by the facility, in turn, selling securities to the public. The securities sold by the facility could be based on pools of mortgages from several banks (or securities bought from these banks which provide funds to the facility from the mortgage payments and repayments of principal).

Actions to Date

While a number of the concepts outlined above have been discussed within the government and between the government and the Central Bank, little action has

[23] It would be simpler for the facility to purchase mortgages or participations in full mortgages, rather than to purchase securities based only on the negative amortization (so-called "strips," i.e., stripping some of the income from the mortgage from the main part). The objective to the program--to provide increased liquidity--would be realized under either option. But investors would more easily understand investments based on full mortgages.

occurred. Indeed, with the exception of some movement on creating reliable registration systems, no concrete steps have been taken.

E. Conclusions

The foregoing discussion makes clear the embryonic state of mortgage financing in the Russian Federation. It is extremely difficult to forecast the pace of future development because so much depends on government: both in arresting the dangerous rates of inflation and in establishing the broad conditions under which mortgage lending can be undertaken on terms protecting both the lender and borrower.

In this context it is doubly surprising to see banks apparently ready to begin long-term mortgage lending. There is, of course, extreme pressure to do so by republican governments as well as the Federation government in order to save existing construction firms from bankruptcy and thereby maintain employment levels. As mortgage lending begins, it appears that it will be characterized by continued use of the fixed rate mortgage interest and those few borrowers who are able to secure loans will enjoy extremely low interest rates, thanks to a policy of subsidizing these loans from a combination of direct government assistance and cross subsidization from the higher rates charged on commercial loans.

This quite gloomy picture is quite consistent with the experience elsewhere in Eastern Europe, where reform of the typically much more development housing finance systems has been slow.[24] On the other hand, one can take some encouragement from the presence in government of individuals who understand what needs to be done. Converting this conceptual strength into action will take some time, but some real action may be seen in 1993.

[24] See Baross and Struyk (forthcoming).

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