Chapter VI
FINANCIAL FRAMEWORK

A. The current situation

1. Investment in housing

Total expenditure and trends

In 2001, the Government invested R 360 billion in local authority housing. In 2002, that amount was expected to rise to R 540 billion. In 2001, R 170.6 billion (47.7%) was covered by user fees and R 129.1 billion (35.5%) from budget funds. The deficit of R 60 billion (16.8%) was dealt with as follows: Services that had already been supplied (electricity, water, heating) were simply not paid for. This led to rising losses among producers. Some services foreseen in the tariffs were not supplied. These include, above all, fundamental renovations to buildings. This results in properties and their installations deteriorating at an ever-increasing rate.

Cross-subsidizing constitutes a further problem for financing. Electricity and gas, in particular, are supplied to customers at below-cost prices. The suppliers then demand excessive prices for supplying other services to finance this. This means that providing cheap services in one sector leads to higher prices in others.

According to Russian experts, for 2002 there is evidence of a rising trend in the cover from user fees.[25] There are also signs of a shift in government expenditure from the municipalities to the regions. In the residential construction sector, there are clear signs of an increasing trend in private investment and a decline in government investment. Although the number of completed houses virtually halved from 1990 to 2001, the proportion of private financing more than doubled in the same period. The proportion of private investment is also increasing according to the working groups on housing policy and the development of mortgage credit of the State Council of the Russian Federation. According to their data, the volume of state-financed housing fell from 76.0 million m² in 1987 to 33.8 million m² in 2001. By contrast, the volume of privately financed housing rose from roughly 3 million m² in 1987 to around 13 million m² in 2001.[26] However, the volume of mortgage loans remains low:[27] the sum of US$ 50 million equates to 0.1% of GDP.

Potential sources of funding

There are a number of potential sources of funds for the housing sector.

Tariff structure and social subsidies

Restructuring the tariff system for local authority services (electricity, gas, etc.) and putting an end to cross-subsidizing are likely to free up public funds. How far the various costs can be allocated to consumers needs to be decided for each sector. In this connection, a system of aid would need to be introduced for low-income households to enable them to pay the rising fees. This will prevent equal subsidies going to all households, including those whose income is sufficient. In addition, subsidies could be reduced or even abolished for individual households whose income rises.

Housing development funds

Housing development funds, which are dealt with in greater detail in chapter XI, could be financed from government income (in particular, regions and municipalities) from the sale of land or rights to land. They could – as will be shown – assume a central role in developing housing finance.

Taxes

Finally, the introduction of a property tax

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[25] Using older data: Sivaev, Sergey: Housing Sector Reforms; in: Kosareva, Nadezhda B. / Struyk, Raymond J.: Urban Management Reform in Russia, 1998 – 2000; 2001, Pages 114 – 134 (115, 116).

[26] State Council of the Russian Federation – Working group on housing policy and the development of mortgage credit: Illustrated materials; Moscow, February 2003; diagram 3.

[27] Data from: Stupin, Ilya / Chajnikov, Juriy: Resultat zybkogo kompromissa; Ekspert #26(381), July 14, 2003.

(housing, land etc.) could be considered as a further option. This will also be dealt with in chapter XI.

2. Instruments and institutions

Due to the lack of legal foundations, various models of property finance have developed in practice. The basic structures are outlined below.

Co-investment model

This form is used for housing construction by private investors and is widespread. An investor acquires a lease on a piece of land for 49 or 99 years from the town or municipality. Since the new Land Code has not yet been implemented in most regions, the investor cannot acquire ownership of the land. The investor plans to erect a multi-dwelling unit on the leased land. As compensation for the lease, the town or municipality frequently receives a specific rate of the finished flats. The finance is usually organized as follows: future owners of the flats (so-called co-investors) initially pay some 30% of the value of the –yet unfinished– flat. They make regular payments to the investor during the construction. As security, the co-investors are awarded a claim against the investor for completion of the flat. The financial means (down payment and subsequent installments) can be raised as a loan from banks. However, until completion of the flat and its registration in the uniform state register of property rights the bank has no collateral. The bank cannot have a mortgage registered until the flat is registered. Sometimes banks demand higher interest rates until the mortgage is registered, in addition the claim by the co-investor/borrower against the investor can be pledged. However, there is no collateral in the event of the investor/property developer going bankrupt. As a result, banks admit that they become involved in projects of this kind only if they know the property developer and have worked successfully with him in the past. This naturally makes it difficult for new property developers to enter the market.

Besides the risks for the financing bank, there is a risk for the co-investor/borrower. During the building period and until completion of the flat's registration he has to trust the developer. It is unclear what would happen to the borrower in the event of bankruptcy or fraud on the part of the developer.

Furthermore, the legal procedure of purchasing ownership of the flats seems unclear. The financing is sometimes supplemented by the option of saving up equity (for the first instalment of 30%) with the banks that will subsequently provide the finance. However, these savings options relate only to concrete projects. The saver must stipulate at the beginning (when the contract is concluded) why and for which specific project he is saving.

These forms of finance are used only for new residential construction, not for renovating existing housing. In addition, they are only accessible to high earners.

For co-investment contracts it is absolutely necessary to improve the civil law legislation on real estate, registration and mortgages. Moreover, for this technique, it is especially important to have a law on property developers. Regulations are needed on the transparency of their financial status and management, as is an efficient and supervised system of protecting co-investors from the risk of fraud or bankruptcy of the developer. The current system based on acquaintance can then change into a transparent market system.

Regional programmes

Following the 1998 crisis, when banks withdrew from the property financing, some regions and towns or municipalities developed their own mortgage projects. These were and still are largely financed from budget funds.[28] Institutions were set up to work with the Federal Agency for Housing Mortgage Loans (AHML) as were institutions to obtain funding through issues on the capital market (e.g. Irkutsk Regional Mortgage Agency).[29,30]

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28 More detailed information: Pastukhova, N. S. - Rogozhina, N. N.: "Principal changes in long-term residential mortgage lending in Russia" in: Kosareva, N. B. / Struyk, R.: "Urban Management Reform in Russia, 1998 – 2000"; Page 135 (148 – 158).

29 www.ipoteka.irk.ru.

Most regional programmes are based on budget funds. However, these programmes may strain public budgets since there is no clear legal demarcation between loan programmes (via banks, agencies or other legally independent institutions) and development instruments. In the event of recurrent economic instability, this may constitute a risk since there is no cushioning via banks, agencies, etc. as market participants and financial intermediaries. Budgets are also substantially exposed to the risk of interest rate changes and from time to time to the risk of credit defaults. Finally, the regional programmes are of minor significance in terms of volume because of the public sector's constrained financial position.

By and large, the programmes tend to be small because of the lack of budget funds. There are various reasons for the government's willingness to become involved at the respective level:

(a) To deal with regional housing problems;

(b) To strengthen the economy with capital inflows. In this connection, budgets are to be used in addition to private savings and other private sources;

(c) In addition, there is a demand for transition systems for property finance until the macroeconomic situation stabilizes with a reduction in interest rates.

Budgetary support is provided through, for instance:

(a) Interest subsidies to selected banks (offsetting the difference between market interest rates and actual lower preferential interest rates of the subsidized loans);

(b) Loans from the budget at below-market rates;

(c) Establishment of in-house (on balance) lending and funding institutions.

The regions are starting to use more market-driven models for housing finance, mainly based on development funding institutions to attract capital market resources (e.g. Samara, Irkutsk, Orenburg).

30 In recent years credit funds providing loans without own capital as defined under banking law and providing new loans direct from the repayments (the Sarov model) have been used in some towns, but they have become less important and are not discussed here.

Federal Agency for Housing Mortgage Loans

In 1996, the Government established the Federal Agency for Housing Mortgage Loans (AHML)[31] to create a secondary market. It was modelled after the United States agencies Fannie Mae and Freddie Mac. In 2002, its share capital was increased to 690 million roubles (US$ 23 million). Subsequently, AHML adopted a more active role: new standards for mortgage finance were drawn up; and AHML started cooperating with regional agencies. In the meantime, it has concluded agreements on cooperation with 60 regions in which it assumes responsibility for funding mortgage loans and sets the framework for the regional programmes. Its aim is to achieve a structure in which it acquires mortgage loans from regional "operators", which it then funds via mortgage securities for which it obtains a guarantee from the Russian Federation. These government-backed securities are then purchased by pension funds. AHML has not received a banking licence from the Central Bank. The Federation's guarantee covers capital and interest on AHML debentures for their entire term. The maximum amount of the federal guarantee is stipulated annually in the Federation's budget. Until 2008, the assumption of guarantees totalling R 9 billion is envisaged. Thereafter, the guarantee will expire, according to current plans.

Moscow Mortgage Agency/Delta Credit

Apart from AHML, the Moscow Mortgage Agency and Delta Credit bank also specialize in mortgage lending.

Moscow Mortgage Agency

In 1999, the Moscow city government established the Moscow Mortgage Agency (Moskovsoye Ipotetshnoye Agenstvo (MIA))[32], which has in the meantime received a banking licence. Its main task is to organize a secondary market in Moscow to fund mortgage loans. Fundamentally, it therefore belongs to the group of regional programmes. However, it should be dealt with separately because of its highly developed system.

31 www.ahml.ru.

32 www.mia.ru.

MIA acquires mortgage loans from associate banks, which are funded by issuing debentures secured by a charge on the mortgage assets. In addition, MIA has obtained a guarantee from the Moscow city government for its debentures. The Moscow city guarantee covers only capital on the debentures, not interest. MIA is mainly involved in commercial credit in roubles since it has difficulty competing with AHML products in the residential construction sector in roubles because of its federal guarantee.

Delta Credit

The Delta Credit bank[33] (established with funds from the United States-Russian investment fund Tusrif) is currently one of the most active players in the residential mortgage market. More than 10 banks in Moscow and St Petersburg cooperate with Delta Credit in the residential construction finance sector in United Sates dollars.

Banks in general

Banks view the long-term mortgage business as promising. However, the interest of banks, such as Sperbank, Vneshtorgbank, National Mortgage Company, the Austrian Raiffeisenbank and EuroTrustBank, in mortgage lending is growing. An interesting example is the recently created City Mortgage bank (Gorodskoj Ipotechnyj Bank)[34], a joined bank of Trojka Dialogue (leading Russian investment bank) and Rosgosstrakh (one of the country's biggest insurers). The Bank is going to sell its credits nationwide through branches of Rosgosstrakh.

At the same time, more and more banks are using mortgages to secure loans. Several banks use a three-sided purchase-sale and mortgage agreement, which is concluded between the seller of the property, the buyer/borrower and the bank/lender. Ownership of the property can be assigned virtually simultaneously and the mortgage on the property is created through agreements of this kind.

General observations

Elements of modern property finance are in principle present in the systems outlined (saving up to create equity, bridging finance at the start of construction, long-term mortgage finance of purchase, funding via the capital market, government subsidies to promote residential construction). However, successful further development will depend crucially on clearly demarcating the various systems legally and systematically and adapting them to the demands of the market.

B. Current problems and challenges

1. Civil and enforcement law

Separation of land and buildings

The main problem in civil law remains the separation between land and the buildings on it. This makes lending by banks particularly difficult in the initial phase of the financing, when there is no building that can be registered and consequently mortgaged. The Land Code, which came into effect in 2002, provides for solutions but there is still a general lack of regional implementation laws.

Enforcement of homeownership, eviction of the previous owner

Under the Civil Code the registered owner of a mortgaged property cannot be evicted from the property by means of foreclosure. While the lender (usually a bank) can – on the basis of the Law on Mortgages – bring an action for eviction, it cannot enforce this judgement. There are also reports that in some cities the local authorities are entitled to accommodate homeless people in any property.

Position of the mortgage in bankruptcy

On 2 December 2002, the new Law on Insolvency (Bankruptcy) came into effect. It contains new regulations on the distribution of a bankrupt's estate.[35] One of the main criticisms of the old 1998 Law on Insolvency (Bankruptcy) was the unusually poor position of creditors whose claims were secured by charges. They were satisfied only

[33] www.deltacredit.ru.
[34] www.gorodskoi.ru.

[35] See Wedde, Rainer: Neues im russischen Insolvenzrecht (Changes to Russian Insolvency Law); WiRO 2003, 195 – 200 on this subject.

third (of five ranks) and no separate satisfaction from the pledged asset was possible. Under the new Law there are only three groups of creditors (art. 134). In the first place – as is generally the case in insolvency law – the costs of the proceedings are satisfied. This is followed by the first group, namely creditors to whom the debtor is liable because of death or injury. The debtor's employees and author’s copyrights follow in the second group.

All other creditors are satisfied in the third group; there is no longer any differentiation according to claims secured by charges, budget claims and off-budget claims (art. 137). For creditors whose claims are secured by a charge, however, article 134 (4) 2 provides for separate satisfaction from the pledged asset. Compared with the previous legal situation, this change constitutes massive progress. However, a number of questions remain open: in the first two groups registration of claims is also possible after the actual registration period ends, which means that disbursement of the proceeds to the secured creditors will be delayed. The relationship vis-à-vis the costs of the proceedings is unclear: can the pledged assets also be used to settle these? It is also unclear who realizes the pledged asset. From a legal viewpoint, it is interesting that the order of satisfaction in the liquidation of a legal person in article 64 of the Civil Code was not changed, in that it still provides for five groups (as the old Law on Insolvency of 1998); this order also applies to insolvency proceedings via article 65 of the Civil Code.

Registration

Under article 2 of the Law on the Registration of Property Rights and Transactions, every disposition over property (purchase, creation of a charge, etc.) must be recorded in the uniform state register of property rights. However, the significance of this registration remains unclear. As a result of this there have been different interpretations between the Supreme Court and the Highest Court of Arbitration.

There were problems with registrations that were effected following the privatization of housing where there were mistakes in the privatization proceedings. It would seem that the Supreme Court used the mistakes as an opportunity to declare the privatization invalid – contrary to the records in the uniform state register and the sales that had taken place subsequently. In similar cases, the Highest Court of Arbitration decided that the purchaser could rely on the record in the register. [36]

Notary's fees

Official recording by a notary is needed to conclude the creation of a mortgage. The notary's fees amount to 1.5% of the loan. This constitutes a major impediment for many contracting parties since this means that the provision of collateral by means of a mortgage is made far more expensive.

Conclusions

The position of mortgages as a means of providing collateral for loans must be improved. The following regulations are recommended for this purpose:

(a) Option of evicting the owner from the property that has been sold by auction. (At the same time social security provisions need to be in place for providing alternative accommodation to the owner);

(b) Further improvement in the position of mortgages in insolvency (full right of separation of the mortgaged (pledged) real estate from the general bankrupt’s estate and realized only in favour of the mortgage (pledge) secured lenders);

(c) Complete public trust in the uniform state register.

2. Banks and the financial market

Commercial banks and other mortgage lenders

The main problems for banks and other mortgage lenders are:

(a) Credit risk, essentially the risk of enforcement (sale of the property and eviction of the previous owner, see above legal problems);

(b) An absence of long-term funding options. Today, banks are essentially dependent on their short-term deposits for funding long-term loans, making it difficult to manage their assets/liabilities;

(c) Currency risk. Moscow and St Petersburg

[36] OWC (Ost-West-Contact) supplement 7/2003, P. 25.

banks, in particular, provide loans in hard currency (especially United States dollars) at fixed rates. However, the vast majority of borrowers have earnings in roubles. In the event of strong fluctuations in the exchange rate (devaluation of the rouble), the banks run the risk that borrowers will no longer be able to repay the loans;

(d) Interest risk. Regional lenders largely refrain from dollar-denominated loans but provide loans in roubles at variable rates. If rates rise sharply, there is a risk that borrowers will not be able to pay.

(e) Low incomes. Individuals declare only part of their income officially to the tax authorities. Their aim is to cut their tax bills and, in particular, their social insurance contributions. As a result, it is difficult or impossible for lenders to obtain a reliable picture of their clients' creditworthiness. Given that Russian tax rates are low, this problem is largely psychological, arising primarily from the fear that income tax will be raised following disclosure of all earnings. The only solution is a tax policy that is stable and trustworthy in the long term.

AHML – Current problems and possibilities for further development

There are considerable doubts concerning AHML activities in terms of both its business plan and its structure as a whole. Under its current business plan, AHML takes over mortgage loans in roubles from regional operators (regional agencies, etc.), which themselves have acquired the loans from banks.[37] Account must be taken of the fact that each of these participants in the system receives fees in this connection. This makes it far harder to make the loans cheaper for borrowers.

A further risk – resulting from the one-sided guarantee for AHML – is the risk of a government-established or sponsored monopoly emerging. These monopolistic institutions have a long and mixed history in a number of countries. Government monopolies generally offer explicit or implicit public guarantees and related contingencies. At the same time they are more exposed than competitive private banks to policy interference. In several countries these monopolies have slowed the entry of private banks into mortgage finance. Such an outcome in the Russian Federation would be detrimental to the objective of producing more housing units.

The system of government-backed agencies, like AHML, in a country in transition is likely to be a problematic vehicle for trying to build up a non-monopolistic free market system and can lead to significant burdens being placed on the government budget. The preferential treatment by the Government of AHML could drive other providers away from the housing finance market. In addition, the transfer of credit risk in the mortgage market to the Government constitutes a considerable potential threat to stability and growth for any country in transition, which is still weak financially and burdened with a backlog of infrastructure investment.

There is also the risk that the policies governing AHML do not adequately fit into the overall housing policy context. By subsidizing the lender (AHML) instead of borrowers, there is a risk that the desired housing policy effect will not be achieved and that significant budgetary problems can be expected in the future instead.

It is to be welcomed that AHML plans to subject its activities to the new Law on Mortgage Securities. This is an important step in the development of equal opportunities for all competitors in the market. It is also positive that AHMLs’ guarantees are limited to 2008 and that their amount must be stipulated by law each year in the federal budget.

For the future, consideration should be given to the direction in which AHML develops. In principle, there are two options: privatization and conversion into a private financial institution or development into a federal housing development fund.

In the event of privatization, AHML could continue its current business model (purchase of mortgage loans from regional operators and the provision of funding for them) albeit without a federal guarantee. In this context conversion to a specialized credit organization would be recommended. As a result, AHML would be

[37] Semenyaka, Aleksandr N.: Mortgage lending as a key factor for the decision of the housing problems”; Conference “Mortgage in Russia”; Moscow 3 April 2003 .

subject to banking supervision – instead of merely securities and investment regulation. This would introduce further security, which would be an advantage for bondholders.

In contrast to privatization and conversion into a private financial institution, consideration should also be given to converting AHML into a federal housing development fund. This would enable it to discharge the duties of promoting residential construction at a federal level – in addition to similar activities of regional funds. This could be supplemented by the responsibilities of a federal housing regulator, which would serve as a central federal unit to develop and implement a federal housing policy. In this case, however, AHML would have to give up all its lending business and withdraw completely from the market.

Banking regulations

Another problem for mortgage finance is the lack of banking regulations. As shown above, savings models and funding systems based on securities are used today but, since there is no legal provision, various problems occur. For instance:

(a) Uncertainty for investors in funding securities and savers in the savings systems;

(b) No statutory standardisation of the schemes for savings, own capital and mortgage funding systems. This leads to a lack of transparency and does not facilitate effective investment decisions;

(c) A lack of flexibility since banks and other institutions will provide finance only for specific projects where they know the investor in order to help get over the legal problems.

The following areas should therefore be regulated:

(a) Saving with savings and building societies (Bausparen);

(b) Mortgage lenders and funding through mortgage securities (improvements in the Law on Mortgage Securities)

(c) The law on property developers;

(d) The credit bureau.

C. Developing the financial system

This section looks at proposals for developing the financial system, with a focus on using mortgages to secure loans and developing the financial instruments needed.

1. Developing mortgages to provide suitable collateral for a loan

The Law on Mortgages (Charges on Property) was introduced in 1998. It represents a major step towards a system of securing property finance. However, it must be supplemented with an effective system of using mortgages to secure loans. International experience has shown that the following is a concrete legal precondition for the introduction of mortgage lending.

Clear and secure laws on property rights

The ownership, use and disposition rights over property should be clearly defined by civil law. This includes the definition of property, the secure regulation of ownership and other rights to property. Apart from the owners' rights, third parties' rights, in particular, those of tenants and lessees, should be stipulated precisely.

A reliable cadastral and registration system is a precondition. As experience in other countries in transition that have introduced mortgage lending and in Western Europe shows, a practicable register must fulfil the following criteria:

(a) Complete cadastral recording of the plots of land and other properties;

(b) A register (land register) that shows all the legal relationships clearly;[38]

(c) Constitutive (establishing a right) effect of registration;

(d) Mandatory registration for new rights;

(e) Public faith in the accuracy of the registration;

(f) Ongoing updating of the register;

(g) Professional qualification of those maintaining the register;

(h) Adequate personnel and material resources for the register's authorities;

(i) Official liability rights against the government if the register's officials have acted incorrectly.

[38] The requirements of a modern land register were summarized by Professor Hofmeister in a comparative legal study "The modern land register", which was issued in 1992 by the Austrian Society for International Cooperation in the Notary's Office and the Austrian Ministry of Justice. This work was also translated into Russian.

Problem-free creation and enforcement of loan collateral

Only those mortgages which are not reduced in value by preferential rights are suitable as a basis for short- and long-term property finance. Therefore, the following points are to be taken into consideration:

- It must be stipulated by law which registered and unregistered creditors are to be satisfied from the proceeds if the property is sold and in what order. The situation has improved thanks to the new Law on Insolvency (Bankruptcy) but is still not resolved unequivocally;
- The claims that are not recorded in the register but are to be satisfied from the sales proceeds are to be restricted to those that relate to the piece of land, e.g. land tax or land development costs. Situations where general tax claims or tax claims unrelated to the land that are not recorded in the register can rank ahead of registered rights to the land must be excluded;
- An insolvency fund into which a proportion of employment income is paid should be established to protect employees and their claims. In the event of bankruptcy, employees' claims will be satisfied from this fund. They would then no longer participate in the insolvency proceedings;
- There must be no charges that make the sale unattractive for the creditor. It should, for example, be possible to evict the owner who fails to pay up. At the same time, effective government instruments must be in place to protect individuals against homelessness.

Rapid feasibility

Property transactions should be swift and at reasonable cost. Taxes, registration fees, notary fees and other expenses should not be so high as to make property unnecessarily expensive and prevent the development of a market. Moreover, the fact that property transactions can be carried out quickly must be guaranteed. This relates above all to speedy official recording by the notary and registration.

2. Generating funds

Regional/municipal level

Funds for housing

In particular, sales of land and rights to land should be used to remedy the lack of capital at a regional and municipal level. This could raise large sums, especially in view of the privatization of land that is imminent under the Land Code. Public landowners are already selling rights (leases) to investors who are constructing residential and commercial buildings on the land.

Today, the funds which the regions or municipalities receive seem to flow directly to the regional or municipal budget. All, or in any event some, of these funds should be aggregated in a fund for the local or regional government, which could be used to promote housing ("housing development fund") and administered separately from the rest of the budget.

If necessary these funds should be created as new institutions or within existing institutions. The aim is to have reliable and sustainable income for the development of the housing sector. This is a precondition for developing and implementing a public assistance system for households to improve their housing conditions. Beside the question of the institutional organization, it is necessary to improve the efficiency of the existing subsidiary systems, a better targeting of the resources and a higher level of budget transparency.

The improvement and reorganization of the public subsidiary system can be successful only if there is also an improvement in the legislative environment, a removal of administrative barriers, and more interest of banks in mortgage lending.

<u>Use of the housing development fund</u>

The fund should be used to:

- Establish financing institutions tailored to market demand. As described above, many regions are developing their own mortgage programmes, which include both savings elements and mortgage lending and in some cases funding from securities. Since private banks' interest in residential construction remains low, the public funds should not simply be used for open or hidden subsidies or a "social mortgage" but to establish a property finance system that is compatible with market conditions and in which support is provided for social target groups;
- Promote social housing construction[39] for social target groups. Today, all borrowers are subsidized via the various regional mortgage programmes without social target groups being reached sufficiently effectively. This situation must be improved by separating the financing institutions and the development institutions.

Taxes

The option of introducing a property tax (on housing, land, etc.) should also be considered. This might be based on the principle of the assessed value of property, a system used, for example, in Germany. This system takes into account potential rental incomes and construction costs. This assessed value of a property lies well below its market value, which generally fluctuates. The tax rate is set by the municipalities.

Consideration could be given to converting today's normal rents for leasing land into a property tax. This would bring more real estate into the circular economic flow through the privatization of land (and encourage the development of a market) and, by bringing together land and the buildings on it, would solve many practical and legal problems which are preventing the development of a property and lending market.

[39] “Social housing construction” has to be understood as public assistance for the purchase, renovation or building of houses/flats to particular segments of society that cannot afford a mortgage without this assistance.

The regions and municipalities would not be disadvantaged by such a tax.

Federal level

The measures discussed above should be supported at the federal level through an appropriate fund to promote housing and housing construction. This can be fed from the Federation's income from the sale of its own property or rights to property. A levy on the production, sale and export of oil and gas to generate funds to this end is also conceivable.

3. Capital markets (pension funds)

According to the Law on Investment of Funds to Finance the Savings Portion of the Employment Pension of 24 July 2002 and the Law on Non-government Pension Funds of 7 May 1998, government and private pension funds may invest some money in securities (government securities and mortgage securities).
The former Law limits investment in securities, apart from government securities, to diversify risk: investments with one issuer and the group associated with it should not exceed 5% of the portfolio. In terms of the quality of securities that may be acquired by the pension fund, the latter Law provides that the investments should guarantee the preservation of the pension contributions and the diversification and liquidity of the investment portfolio.

Mortgage securities should therefore be structured in such a way that they do not need a government guarantee because their legal structure and standardization makes them so secure. Otherwise, buying these securities would also be only an (indirect) investment in government securities. Therefore, risk would not be diversified nor would pressure on the government's budget ease. In addition, the right to issue should not be limited to one issuer since in that case it would be impossible to comply with investment limits and it would be difficult to ensure the securities' liquidity. With only one issuer there would also be no opportunity for pension funds to diversify.

4. Development of institutions

The mortgage-based financing system that is to be developed in the Russian Federation must fulfil various requirements. It must be suitable for all types of property finance (purchase, construction, renovation) and for both residential and commercial property.[40] In addition, it must combine the various features such as saving up equity, long-term lending using the capital markets and the option of cooperation between the various institutions and the option of government assistance. Three or four different institutions should be established for this purpose**:**

(a) Mortgage lenders whose funding is based on securities (attracting institutional investors, especially pension funds).[41] These mortgage lenders can provide mortgage loans themselves or acquire the loans from other institutions;

(b) Institutions for saving up equity for construction finance;

(c) Development funds for housing construction (this can also be effected via the proposed housing development fund). The development funds must, however, be deployed in a way that is competition-neutral, i.e. also for borrowers who obtain their finance from private lenders. The development of these institutions will open several business and cooperation opportunities for the institutions involved;

(d) Possibility of introducing a system of public sector lending, in particular refinancing public credit guarantees to the borrower.

Several municipalities and regions could cooperate with private banks to establish and develop these institutions. The privatisation of these institutions should be given as a binding goal for their subsequent development.

In the following, several aspects which relate to the four institutions mentioned will be discussed:

(a) <u>Introducing a mortgage security, usable by institutional investors without State guarantee</u>

The question of competition between covered bonds as special bank debentures and mortgage backed securities (MBS) (to which the "mortgage share certificates" and especially the mortgage obligations issued by mortgage agents correspond in the new Law on Mortgage Securities[42]) is currently one of the most debated in Europe. Neither is better. Both have their own role. The covered bond serves as a means to procure original capital, that is to fund assets. By contrast, MBS are a means of selling assets to relieve bank balance sheets of risk and to release shareholders' equity. Covered bonds and MBS complement each other with their different characteristics and purposes. The markets in which they are placed are correspondingly different. MBS are securities that pass the risk to the investor. They are therefore suitable for investors who are capable of and willing to assess the investment risk individually. However, the focus of the securities on this target group is not required if, as was the case of the major United States agencies until a few years ago, there is a general government guarantee against default.

MBS

In Europe, there is no government liability of this kind. Instead the quality of the payment flows, which are passed on from issuers not only economically but also legally in the case of MBS, is checked by rating agencies. The interest rates

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[40] Also agricultural land

[41] The World Bank's proposal that mortgage agencies should receive banking licences in order to conduct lending on this basis goes in a similar direction (World Bank: Developing residential mortgage markets in the Russian Federation – Final report ; December 1, 2003; No. 53).
Moreover, without further special legislation in this area (above all laws on mortgage securities and saving with savings and loans associations) the granting of banking licences does not seem sufficient.

[42] Articles on the new Law on Mortgage Securities:
Djemushkina; Ekaterina:
- Opredelenije pravogo statusa ipotetschnoj zennoj bumagi; Rynok zennych bumag (RZB), No. 24 (255) 2003, p. 32 – 39.
- Konzeptual'nye podchody k opredeleniju pravogo statusa ipotetschnoj zennoj bumagi; RZB No. 1-2 (256 – 257) 2004, p. 67 – 72.

Lassen, Tim: Wiedereinführung Pfandbrief-ähnlicher Wertpapiere in Russland (Reintroduction of Pfandbrief-type securities in Russia); Immobilien & Finanzierung 2004, p. 120 – 124.
Weiland, Hans-Otto / Lassen, Tim: § 18.5: Mezhdunarodnaya Ekspertiza Zakona „Ob ipoteschnych emissionych zennych bumagach“ in: Agapkin, V. M. / Chernyak, A. V. / Chernyak, V. Z. (publ.): Zhile – kompleksnyj vzglad; Moscow 2001, p. 722 – 740.

for MBS are geared to the interest rates prevailing on the capital market at the time of issue and the securities' rating. It is normal for MBS to be divided into various risk tranches.[43]

MBS are complex transactions requiring a great deal of documentation and the costs of this kind of transaction are correspondingly high. If a special purpose vehicle (SPV)[44] is involved (corresponding to a mortgage agent under the new Russian law), further transfer costs will be incurred.

In the Russian Federation, the introduction of MBS-like structures through mortgage bonds issued by mortgage agents is being considered. Mortgage agents are joint-stock companies without their own staff, which are managed by a parent company that must not be a bank and which receive their assets, on the basis of which they issue mortgage bonds, from the parent company.

It should be noted that it is not easy to achieve the resistance to insolvency demanded for SPV structures.[45] In addition, the decisions on the allocation of assets to SPV are not made by the issuer but by the entity transferring the claim by selecting the transferred loans. All actions of relevance to the supervisory authorities do not take place with the issuer but elsewhere. Furthermore, since SPV have no staff, it is not clear who would be responsible for certain supervisory measures.

In a more advanced capital market with more specialized and sophisticated investors, MBS will have their role as a part of structured housing finance. As in other European countries through MBS the risk of credits higher than 60% or 80% of loan to value may be sold to the capital markets.

Mortgage share certificates

The mortgage share certificate is a registered security which confirms:

(a) Its holder's share in the total title to the mortgage cover;

(b) The right of the person issuing the paper to demand appropriate fiduciary administration;

(c) The right to receive funds from the fulfilment of liabilities for which the claims create the mortgage cover.

The structure seems to follow that of the investment funds in the Law on Investment Funds. Claims secured by mortgages are allocated to the fund as securities. In line with the structure of the investment fund, the aim is to introduce an anonymous aggregate group of creditors with respect to a large number of mortgage loans, which will then be administered on a fiduciary basis. This does not seem entirely harmless under property law.

As far as is clear, the investor in share certificates carries the full default risk on the mortgage loans. There is also no government guarantee for the paper.

From the viewpoint of investors, mortgage share certificates do not seem very attractive because of their complicated structure, which may deviate from general property law, and the lack of security (the purchaser carries the full credit risk).

Consideration could be given to using the options envisaged in the Law on Investment Funds to create and develop property funds instead of mortgage share certificates (art. 33, para. 2). In the EU, these property funds are important associates of mortgage and commercial banks as borrowers.

Moreover, the possibility that security investment funds act as investors in bonds with mortgage cover and consequently a further institutional investor appears – in addition to pension funds –

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43 This procedure – if possible by two rating agencies – is also suggested by the World Bank (World Bank: Developing residential mortgage markets in the Russian Federation – Discussion draft; May 8 2003; No. 53, 54). However, this increases the cost further and makes the loan more expensive for the borrower.

44 SPV = special purpose vehicle. Legal entity, normally without own staff, where the assets are transferred to. The SPV issues securities (depending on the assets mortgage-backed securities (MBS) or asset-backed securities (ABS)). The aim of granting a special legal entity is to try to obtain a bankruptcy-remote structure in case of bankruptcy of the institution (bank or agency) founding the SPV.

45 Reason, Tim: Securitization: False Security? in: CFO Magazine, 16 June 2003.

should be promoted. They could be included in article 33, paragraph 1, of the Law on Investment Funds as a new type of security.

In this way, complementary rather than competing instruments would appear. Competition between different providers, not different systems (here types of security), is necessary for the stability of the market.

Covered bonds

On the other hand, mortgage banks and covered bonds are optimal instruments for developing and servicing wide and effective capital markets thanks to their extremely simple and transparent structural features and the security that these allow – at least if the specialist bank principle is adopted.

For this reason, the legislation should focus first on the covered bond (in the new Russian law: a mortgage obligation issued by banks) as it is the instrument most likely to persuade a broad range of investors (domestic and international) to invest in the residential finance market. Through investors' willingness to acquire this comparatively low-yield but secure instrument, cheap funds will be obtained for the housing finance market.

Covered bonds are also increasingly used in countries where common law applies. In 2001, the Asset Covered Securities Act was introduced in Ireland, for example. In 2003, securities were issued in the United Kingdom under the HBOS programme, which is similar to the covered bonds in other European countries but based on a contractual rather than a legal foundation.[46] In future, it is expected that covered bonds will be used increasingly in countries that previously made greater used of MBS tools (such as the United Kingdom, Spain and the Netherlands).[47,48]

The banking role of covered bonds

Lending funded via covered bonds can constitute a stable base only for externally financed investment; only with this restriction can they guarantee the quality that justifies faith in their security.

Covered bonds offer mortgage banks the option of promising the investor very low redemption rates for very long loan terms without delay on the evidence of the loan collateral and also of fixing the interest rate for the duration which corresponds to the long-term maturity of the covered bonds providing the funding.

The most important preconditions for acceptance on the capital market emerge from the correct structuring of the following elements:

(a) A simple and readily comprehensible structure for the financing model stipulated by law;
(b) Statutory and supervisory requirements, which counter risks to the mortgage bank's creditworthiness;
(c) An effective system of government monitoring of the security of covered bonds and mortgage banks;
(d) The expectation that the mortgage banks will regulate prices in the interests of investors.

Securities fulfil this particularly if:

(a) The issuing bank does everything in its own business interests to maintain its reputation and the quality of the securities including market-making (as accepted market practice);
(b) Issuers do not assign their loans but fund them on balance through the issuance of their own securities so that they are liable under the covered bonds; and
(c) The bank's shareholders' equity and other risk cushions serve to protect the securities.

[46] See for example: Damerow, Frank / Barbour, Iain / Hostalier, Katie: HBOS Covered bond – Transaction overview, Commerzbank Securities, 22 July 2003.

[47] In the Netherlands the Banking Association drafted a mortgage bank act to introduce a legal environment for mortgage bonds, based on the principle of specialized banks.

[48] Engelhard, Fritz: Sector Report: Don't stop, and don't be afraid to start; HVB Credit Research Covered Bonds, 21 August 2003, Page 3.

Minimum standard for covered bonds under EU law (Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) art. 22, para. 4)

Covered bonds are not subject to uniform regulations throughout Europe. Nevertheless, EU law sets a minimum standard for covered bonds and comparable securities with which certain alleviations to the supervisory requirements for financial institutions and insurance companies are associated. The EU regulations and the privileges for mortgage bonds in EU law will be discussed as an example of the necessary minimum requirements and the possibilities to attract national and international money by privileging the mortgage bond as investment instrument.

The preconditions for UCITS, article 22, paragraph 4, are:

(a) A financial institution's debentures;
(b) The fact that because of statutory provisions to protect the holder of these debentures they are subject to special regulation that monitors the cover funds. This supervision is not geared to the financial institution's stability but to protecting investors;
(c) By law, income from issuing these debentures must be invested in assets that adequately cover the liabilities arising under the debentures for their entire term;
(d) Preferential right of the covered bond holder in the event of the issuer going bankrupt to be satisfied before all other creditors from the assets recorded in the cover register (preferential right in bankruptcy).

Privileges for covered bonds

Because of this guarantee, covered bonds attract a number of privileges under EU law:

(a) They may account for up to 25% of assets in an investment fund instead of a maximum of 10%;
(b) They may account for up to 40% instead of a maximum of 5% of "committed assets" in the case of life assurance companies and investments in covered bonds;
(c) They do not have to be included in the large exposure limit;
(d) Liabilities under covered bonds do not have to be included in the deposit protection insurance;
(e) Covered bonds are automatically admitted as tier I securities for money market policy operations by the European Central Bank.

This also helps institutional investors since they can acquire the securities without lengthy checks knowing that they will be able to liquidate them at market rates at any time.

Issuers

Under the UCITS directive, the issuer must always be a financial institution. It is irrelevant whether the issuer provided the loans on whose basis it is issuing the security itself or whether it purchased them from other institutions.

The aim is to include a fundamental element of investor protection: financial institutions are subject to general banking supervision and the special provisions for financial institutions such as the rules on equity, solvency, large exposure and annual accounts and consolidation.[49] This is supplemented by the requirement for "special public supervision to protect holders of covered bonds," where the quality of the cover funds is monitored. This supervision is not geared to the stability of the financial institution but to investor protection.

Specialization

The specialist bank principle is a particularly important aspect of mortgage bank law. A specialist bank is a lending organization that is subject to general banking law but is limited by a specialist law to specific areas of operations (its main business being mortgage and public sector lending funded by covered bonds). A specialist bank has its own staff and its own management board. Its business is long-term. A special purpose vehicle (SPV or Russian mortgage agent) for MBS is not a specialist bank.

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49 Bellinger, Dieter: Commentary on Art. 22 (4) of the UCITS directive; in: European Mortgage Federation (publ.): Mortgage Banks and the Mortgage Bond in Europe; 3rd ed. Baden-Baden 2001; point 4.6.

The specialist bank principle is the outer wall protecting covered bonds. In Germany, for example, no "Pfandbriefe"-issuing mortgage bank has gone bankrupt since the introduction of the Mortgage Bank Act (1 January 1900). [50] The additional walls protecting covered bonds are the quality of the cover funds (above all the mortgage lending value) and the preferential ranking in insolvency of covered bond holders in the event of a mortgage bank becoming insolvent. Because of their statutory specialization, mortgage banks are institutions with a portfolio that is overwhelmingly made up of very low risk loans. This contributes significantly to their protection from bankruptcy. The rating agency Moody's and covered bond analysts view the specialist bank principle as an important aspect of their security ("outer protective wall").[51]

The macroeconomic reasons for the specialist bank principle are:

(a) The direct link between the liabilities side (mortgage obligation) and the assets side (cover assets), whereby funding is guaranteed via the capital market. This means efficient, risk-oriented pricing and an efficient allocation of capital. In addition, it is a competitive system: simply because several banks that are regulated by the same specialist law compete with each other. Long-term funding is the precondition for long-term lending.

(b) The concentration of their main business brings important economic benefits for mortgage banks:

- (i) Low funding costs;
- (ii) Specialist knowledge and experience in their main business, highly qualified staff;
- (iii) Necessary special market experience;
- (iv) If applicable, manageable company size, short decision-making channels;
- (v) Flexibility by the bank, proximity to the market;
- (vi) Cost-effectiveness and a good cost/earnings ratio (in Germany 30.5% in mortgage banks, 68.8% in universal banks);

(c) The high security standards imposed by law are the basis for covered bonds as a homogenous securities class. With the specialization of mortgage banks, the appeal of covered bonds also increases for major international (institutional) investors. At the same time, the relatively widespread standardization of mortgage bank business makes for a high degree of transparency in the covered bond market. No additional government guarantees are needed for covered bonds. The capital market benefits from the fact that the highly liquid covered bond is used as a benchmark for pricing other products.
The specialist bank principle is the precondition for effective and sensible specialist supervision by the banking supervisory authorities, which leads to increased security for investors.

Valuation

The security of covered bonds is crucially dependent on the quality of the assets serving as collateral, which is related to the preconditions under civil and enforcement law (see above), and the banking industry security criterion for the individual mortgage loans. The valuation is the basis for this.

The cover must ensure that the claims arising under the covered bonds for capital and interest can be met irrespective of the performance of the issuing bank, i.e. even in the event of foreclosure and insolvency. This presupposes that all risks can be avoided with the assets needed as cover. For mortgage loans this means that:

(a) While the borrower's personal ability to pay is important at the beginning for assessing his creditworthiness, it must not make any difference to the security;

(b) The security must result entirely from the economic and legal quality of the mortgage; and

(c) Consequently, reductions in the value of

[50] Lassen, Tim: Lehren aus der Hypothekenbankkrise (Lessons learned from the mortgage bank crisis), Immobilien & Finanzierung 2003, p. 652 – 654.

[51] Meisner, Norbert: The Market for Covered Bonds in Europe; Deutsche Bank, 4 March 2003, p. 2.
Anhamm, Christoph/Langer, Heiko/Goth, Klaus/Kaplan, Peter: Liquid European Covered Bonds; 3rd ed. ABN AMRO September 2002, p. 4.
Moody's Investors Service: European Covered Bonds: Moody's Rating and Analytical Approach; September 2002, p. 9.

the mortgaged property that occur during the term of the loan do not reduce its suitability – even partly – as cover.

For funding mortgage loans via covered bonds a valuation “add on” is needed. A decisive point in the decision to take a mortgage credit in the cover pool is not only whether the borrower has the ability to pay the credit back, but whether the real estate will secure the mortgage bonds even if the borrower defaults. To secure the long-term mortgage bonds in these cases the open market value – as today’s value – is not sufficient. Many European countries use the “mortgage lending value”. [52]

In a recently published study[53] the Bank for International Settlements (BIS) found that “the use of current market price is important in generating the cyclic movement of property prices. This occurs despite the fact that expansion of bank credit increases market supply and will eventually cause the property price to fall. The long-term negative effect of bank credit implies that the banks should adopt a valuation method that anticipated market developments.”

The mortgage lending value[54] is not an estimate of the future value or price of the real estate. It is a value-at-risk approach to manage the risk exposure of the bank and it is linked to banking supervisory issues.
The concept of mortgage lending value is based on the following principles:

- A prudent assessment of future marketability;
- Identification and elimination of speculative elements;
- Normal and local market conditions;
- The long-term (sustainable) aspects of the property;
- The current use and alternative appropriate uses of the property;
- Transparent and clearly stated valuation methods;
- Valuations should be carried out by valuers with an appropriate level of competence and following any country-specific rules;

Thus the mortgage lending value is in some ways close to the definition of market value, but introduces, inter alia, a notion that could be described as “smoothing” of market trends, rents and yields. The sustainability of the mortgage lending value may require adjustments to, or discounting of:

(a) The actual rental income of the property,
(b) The market capitalization or discount rate,
(c) The property administration and management costs.

(b) <u>Saving with a savings and building society</u>

The mortgage bank system, which is used for funding via the capital market, might also be supplemented by a system of saving with savings and building societies, which allow the formation of equity.[55] The national economy also benefits substantially from this:[56]

(a) In the form of nest-egg saving it leads to the formation of equity without which a construction project and its actual financing would not be feasible;
(b) The subordinated loans to be secured, i.e. in excess of 60% of the mortgage lending value may be provided (after allocation of the savings

52 for mortgage lending value see:
Kerl, Volkher: Sut’ i znacheniye ponyatiya „zalogovaya stoimost‘“; in: St. Petersburg State University for Economics and Finance / University Potsdam: Tendentsii razvitiya nemetskoy bankovskoy sistemy i opyt dlya Rossii; St. Petersburg 2002, p. 320 – 350.
Rüchardt, Konrad: Mortgage Lending Value; Frankfurt am Main 2003.

53 BIS Working Papers No. 150: Davies, E. Phillip and Zhu, Haibin: Bank lending and commercial property cycles: some cross country evidence; March 2004, p. 19.

54 See The European Group of Valuers’ Associations (TEGoVA): European Valuation Standards 2003; 5th ed. London 2003; S6.04 – S6.11 (p. 72 – 77) (TEGoVA on the internet: www.tegova.org).
The Russian Society of Appraisers (www.mrsa.ru) is a member of TEGoVA.

55 World Bank: Developing residential mortgage markets in the Russian Federation – Discussion draft; 1 December 2003; point 58.

56 Mints, Viktor: Doplata ot Dyadi; “Ekspert” No. 19, 26 May 2003.

agreement) preferentially by savings and building societies;

(c) The savings system achieves the formation of capital through consumer restraint and – as a side effect – has a positive impact on inflation;

(d) The continuous flow of earmarked savings deposits and bank loans has a stabilizing impact on the economy as a whole;

(e) The savings and building society system promotes a constant demand for construction finance that is relatively independent of current interest rates;

(f) Smaller home loan and savings agreements are often used to modernize property for which no external finance would otherwise be available at acceptable interest rates;

(g) The saver learns the habit of saving and depositing money, which will give a favourable impression if he subsequently borrows money from a mortgage bank;

(h) The saving – over longer periods – of capital and the provision of credit at tolerable interest rates also allows households with more moderate or average incomes to raise construction finance.

The reasons for the specialist bank principle apply also to savings and loan associations.

In recent years, a plethora of informal systems have been set up. Customers have put their money into these banks. Either these banks have gone bankrupt or they have taken the customers' deposits for other investment projects and thus have not been able to meet the commitments from the savings and building contracts.

A specific law would therefore protect customers' deposits against the misuse of funds and improve confidence in this type of institution and the Russian banking sector as a whole. In addition, an act on savings and building banks would ensure the stability of the savings and building system since the bank has to fulfil certain requirements to start operations. Such an act would for example regulate minimum savings periods, the waiting period, allocation of loans (after the customer has completed the savings period), securing of the savings and building loans, etc.
The functionality of savings and building systems is not subject to premiums. It is up to the design and the objectives of the national housing policy whether a government provides a premium for savings and building systems. As experiences in Germany, Austria, Slovakia and other countries with their savings and building systems show, their premium schemes have been an efficient tool to encourage especially low- and middle-income groups to save. Through this mechanism, these groups have been able to get access to credit, which would otherwise not have been feasible for them. Moreover, these schemes have been an incentive for them to tackle their own housing problems and to feel more responsible for their own property because they have invested their own funds in the house.

(c) <u>Development of funds for housing construction and business opportunities</u>

When mortgage banks and savings and building societies are introduced, the precautions to which the two systems are subject initially constitute a major hindrance to competition. Commercial banks that are free to choose the risks they incur will first attempt to draw all business to them. They can risk 100% finance and will fight against cooperation with the mortgage banks. Experience has shown that this frequently leads to their having problems and also impedes the establishment of a long-term, fixed-rate financing base that is in the general interest. Therefore, government assistance should be focused on persuading banks to cooperate.

Cooperation in terms of time

Lending to buildings under construction is, for security reasons limited or not at all permitted for mortgage banks. Therefore the borrower needs a credit from other lending institutions for the construction period. The mortgage bank can refund or take over the credit after completion of the building. Under normal circumstances the credit, now secured by a mortgage on the completed building or the land, will be eligible for covered bonds.

This is solved by a loan agreement between the owner and the bank providing bridging finance. It contains the promise of bridging finance and the agreements needed to secure the bridging finance. It also stipulates that the amounts subsequently paid out by the mortgage bank are not to go to the owner but to the bank providing the bridging finance up to the level of the bridging finance.

The owner's own resources

For all credit decisions in mortgage lending, banks must ensure that the risk for the upper parts of the credit is borne by the borrower. This applies to both commercial buildings and residential construction (newly built or renovation of existing housing stock). This ensures that the investor checks the profitability of the project carefully because of his own risk.

In practical terms, full use of the traditional scope for lending of the two groups of specialist institutions leads to 50% of the investment costs being provided by a mortgage bank with covered bond funds and a further 20 to 30% by the savings and building society whose security ranks second in the land register. The owner/borrower must provide the remainder from his own resources.

Also MBS as a risk transfer instrument can be added here to find investors for the higher parts of the credit.

Link with development measures

As already mentioned, the need to provide government assistance may arise if the borrower's income is low or for social policy reasons such as the construction of property to improve the infrastructure.

Fundamentally, the financing structure is similar to that in the previous example. However, part of the resources to be provided by the borrower will be financed by a loan guaranteed by the government (Federation, regions, housing development funds).

The government-backed loan may also be provided by a mortgage bank and funded with covered bond funds, if – as happens in various countries – the issue of public covered bonds, which are covered by government-backed loans, is permitted.

Government assistance

It is expedient to assign the implementation of development programmes, that is the allocation of development funds and the decision on guarantees in accordance with the government's guidelines, to an institution specially created for this purpose (development institute).

Apart from the guarantees described above, an interest subsidy should be introduced as a second instrument that allows large sectors of the population to raise loans. An interest subsidy of this kind could be created via covered bond funded housing loans. As a result, loan conditions that borrowers could pay would be possible.

On the other hand, covered bonds would be promoted as an important capital market instrument. In addition, this subsidy does not subsidize the system, rather it is linked to the borrower's personal circumstances. With the increase in financing options among the population and falling interest rates, this gives the option of withdrawing this subsidy without jeopardizing the covered bond system.[57]

Experience has shown that an adequate housing supply cannot be achieved, at least not at the speed required, without government help. This is particularly true when the need is acute, as was the case in Europe after the Second World War, but it can also develop in rich economies. The United States, which has invested billions of dollars in subsidizing residential construction for many decades, is an example of this.

Borrower protection

It has been shown again and again that dubious or barely solvent entrepreneurs also offer to plan and implement new construction projects for interested parties or to reconstruct or renovate buildings. The contracting parties are often prepared to transfer the amounts needed to cover the construction costs to them prior to completion. It often emerges subsequently that the entrepreneurs are going bankrupt or have disappeared before the buildings are completed or any warranty claims for defective building are met.

[57] Hungary: Moody's Analysis July 2003: Land Credit and Mortgage Bank (FHB), Page 6 – 8.

A tried and tested means of protecting the owners of buildings from major losses of this kind is to force the entrepreneur to provide sufficient security by law and with the threat of punishment. This can be effected by paying the purchase price in compulsory instalments to a bank account to which the contracting party has no access or through a bank guarantee.

(d) Introduction of the public sector loan and the public sector covered bond ("public asset covered bond")

As already indicated on numerous occasions, consideration can be given to introducing public sector covered bonds and public sector lending in addition to the mortgage covered bond ("mortgage asset covered bond"). The mortgage bank provides loans to government institutions instead of mortgage backed loans to entities under civil law. The background is the government's security as a borrower. Since this can be problematic, such an instrument should be limited to loans to the Federation and the regions. However, the instrument would offer the government the opportunity to obtain low-interest loans without having to deal with the sale of paper it has issued itself on the capital market, which would be dealt with by the mortgage banks when selling covered bonds.

5. Government assistance for housing

No country can manage without actively supporting the construction or acquisition of housing. Housing policy is part of social policy.

When formulating the government's policy on assistance for housing, as much use as possible should be made of existing financial instruments or those requiring development (e.g. covered bonds, MBS). However, care must be taken that the use of development funds is open to all market participants (e.g. all mortgage banks, all lenders) and preferential treatment must not be given to individual lenders, e.g. because they are owned by the government.

Aims of the assistance[58]

Assistance for residential construction includes all government measures aimed at providing housing for the population on an appropriate and long-term basis. A distinction should be made between measures to increase the housing stock and measures that aim to retain the existing stock for a broad stratum of the population. Generally the aim of the development measures is also to reduce housing costs for tenants or for owners of an owner-occupied house or flat.

Assistance for residential construction must also take account of the fact that it is a very complex issue in both economic and technical terms and is difficult to regulate with generally applicable laws.

- The demands on residential construction must dynamically follow changes in the way people live together and the general living conditions.
- Rental housing must be managed in accordance with economic requirements if it is to be protected from a decline in the fabric of the building.
- With family homes and owner-occupied flats, the priority is that the owner can bear the burden placed upon him by the property.

Here, too, the fundamental economic principle that no investment is compatible with sustained losses applies. Any assistance must also be targeted at taking account of this aspect in addition to the actual procurement of housing.

Extent of the assistance

Assistance for housing construction is intended to reduce the housing costs for rented property, owner-occupied houses and flats to socially acceptable levels. That is why it should be provided only to the level necessary to ensure housing in line with the constantly changing living conditions.

[58] This section is based on a lecture by Dr. Reinhard Daniel (Retired Head of the Ministry of Social Affairs in Lower Saxony) on 27 June 1996 on the subject "Social Residential Construction in Germany".

Equally important is the level of interest on the loans to finance the new construction or the redevelopment of existing housing. Since interest rates are shaped autonomously in the market and may fluctuate sharply, the only option remains to reduce unbearable burdens with government funds. This can be effected in various ways:

(a) The causal costs are reduced through targeted subsidies for the benefit of the borrower (the subsidies, however, may be given directly to the borrower or through the lending institution) (objective assistance); or
(b) Part of the full burden on the person using the housing is reduced through personal subsidies (subjective assistance);
(c) Both procedures may also be used cumulatively, in particular to take individual account of particular social hardships (unusually low income, large family, etc.).

Methods of assistance

Assisted housing construction finance consists of a combination of government help with the owner's own funds and loans from banks, savings and building societies and insurance companies. This combination can take various forms.

Assistance for property

One aim of assistance to property is to reduce the debt service. In this context, government aid would consist of soft government loans to owners or interest subsidies to lenders.
Government construction loans, which are granted in place of loans carrying normal interest rates or interest subsidies on bank loans, are possible. Interest subsidies are granted on bank loans in order to cover the interest accruing on loans raised in the market in whole or in part.

For the owners of rental housing and the owners of owner-occupied houses it makes no difference whether they obtain an interest-free government loan or the State pays the interest payable on a bank loan for them. However, it does make a major difference to the government's budget.

Construction loans are intended to pay the costs related to construction and must be available during the construction period since they are drawn down in line with construction progress without it being possible to control this to any great degree. They constitute an immediate burden on the government's budget – in terms of both the entire principal and the entire interest burden.
Interest subsidies do not have to be paid until interest is due, i.e. every six months or every quarter. Usually they are not paid until the building is ready for use. The volume of initial government expenditure is therefore relatively low so that large amounts of construction can be quickly financed in cooperation with financial institutions.

When using interest subsidies, it should, however, be noted that this will place a burden on future budgets. While the interest due will diminish annually or after a certain period and a time limit can be placed on the interest subsidies, this does nothing to alter the fact that liabilities for the future will accrue. Assistance for residential construction should therefore not be provided using time-limited interest subsidies alone in the long term.

A second aim of property assistance would be to substitute for own funds, which the owner either does not have or cannot access. The help consists in guaranteeing subordinated loans for the lender.

In cases where assistance is appropriate, it is not possible to provide the financing solely from bank loans. Considerable amounts of own resources, which are unlikely to be available in such cases, are often a prerequisite for banks. Savings and building contracts provide opportunities for creating own funds, as they enable the borrower to obtain a loan of up to 80% of the land, construction and ancillary construction costs once the face value of the contract has been saved. However, there remain gaps in the financing – particularly for people with low incomes. To close the gap, government guarantees to banks have proved relatively simple and low-risk in Western Europe – at least for owner-occupied housing and for flats constructed or acquired for owner occupancy.

Accordingly, a financing package for the borrower can be built up as follows: a loan from a mortgage bank of up to 60% of the mortgage lending value,[59] a loan from a home loan and savings association for the credit portion from

[59] As limit for refinancing mortgage credits through covered bonds.

60% of the mortgage lending value up to 80% of the costs. The borrower receives a bank loan for the missing part of 10 – 20% for which the government assumes a guarantee. The rest, however, has to be covered through own funds. If public asset covered bonds are introduced, the mortgage bank providing the loan can fund this guaranteed part in the capital market with long-term, low-interest securities. As mentioned above, in this structure MBS can be integrated as risk management tool. MBS can be issued by mortgage banks or commercial banks.

Assistance for people

This is intended to support the tenant or the owner of an owner-occupied property who cannot afford the rent or mortgage payments with his income (housing benefit), or to act as a general incentive for creating housing for personal use by constructing owner-occupied houses and flats (owner-occupancy bonus).

Support to the tenant or homeowner who cannot afford the rent or the mortgage payments (housing benefit)

Housing benefit has a social function above and beyond its significance to the housing industry. In terms of assistance policy, its advantage lies in that it can be more precisely adjusted to meet social requirements and it is currently under discussion as an alternative to property-related assistance. In its existing structure its role is not to replace actual assistance for housing construction but is only intended to help hardship cases that remain despite the provision of assistance.

The homeownership incentive is intended to increase borrowers' ability to repay the funds borrowed thanks to government subsidies in the first years after the construction of owner-occupied houses and flats constructed for own use.

Organization of assistance for residential construction

The organization of assistance for residential construction should include all levels within the government. The federal Government, regional governments and local authorities, i.e. districts, towns and municipalities, should be involved in the measures. Their roles and responsibilities should be clearly defined. In Germany, for example, the federal Government creates the legal framework; financing is the responsibility of regional governments. Scrutiny and decisions are largely left to local authorities. The federal Government has become involved in the provision of earmarked financial aid.

All regional governments have largely transferred their responsibility to special "housing construction development offices," which are responsible for administering development funds and subject the applications for assistance from the local authority to banking-type scrutiny.