Selecting a Housing Finance System for Russia

by Victor Mints

INTRODUCTION

One of the most notorious failures of the transition of the Russian economy to a free market form was the failure to establish a housing finance system intended to enable the average citizen to obtain long-term, low-rate mortgage loans. This paper argues that one of the major reasons for the failure was that the housing finance system selected for implementation in Russia was unsuitable for the country.

The Illness and the Proposed Cure

One of Soviet Russia's specific features was the complete absence of a housing market. Practically all housing was public. Developers did not exist. All construction companies belonged to the government. They received funds from a specially established system of "strojbanks" (government constructions banks), built houses, transferred them to local officials, and the latter then distributed the housing units free of charge among people waiting in line. The amount, quality and location of the housing built were regulated by government decisions.

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Market reforms in Russia completely altered the system, turning it into an ordinary market system regulated by demand and supply. The housing market emerged in a form very similar to the market for all commodities. Anyone who wanted to buy a housing unit was supposed to pay for it in a lump sum. Payments were nearly always in cash, and in a foreign currency—U.S. dollars. The average cost of a housing unit during the last 10 years has been about $25,000, while the average annual salary has been about $800. It would seem there should be no demand for housing since it is absolutely impossible for most of the population to accumulate the cash needed to pay for a house in a lump sum.

Nevertheless, the demand exists. Houses are built and sold. Where does the demand come from? The major source of it is the newly emerged group in the population—"the new rich," also called "the new Russians." They buy new homes, the size and quality of which is more appropriate for their new social status than the ordinary Soviet style apartments. The orientation of the housing market towards this group of clients changed the structure of housing supply. The number of oversized houses has grown. From the beginning of the "Gorbachev era," the average size of a housing unit built in the country increased by nearly 40% from 55.5 square meters in 1987 to 79.1 square meters in 1998 (see Figure 1).

As most of the new Russians have now achieved the level of luxury they want, the demand for housing has been rapidly decreasing. During the same 11 years the supply of new housing has fallen by more than 70%, from 1,312 thousand units built in 1987 to 388 thousand units built in 1998 (see Figure 2).[1] It is clear that the market demand for housing will vanish completely unless not only the new Russians, but also at least the group of qualified professionals with annual wages from $6,000 to $12,000 can afford to buy housing units. According to government statistics, this group represents around 6% of the population or approximately 9 million people. These people lack the cash to pay in lump sum, but their income is high enough to repay mortgage loans.

Beginning in the mid 1990s, mortgage loans became available in Russia. Prior to the banking crises of 1998, about 10 banks were involved in mortgage lending. The loans were from six months to two years at an annual interest rate that varied from 17% to 30% in U.S. dollars. Such loans were affordable only to the very small fringe at

Figure 1 Average Unit Size in Square Meters

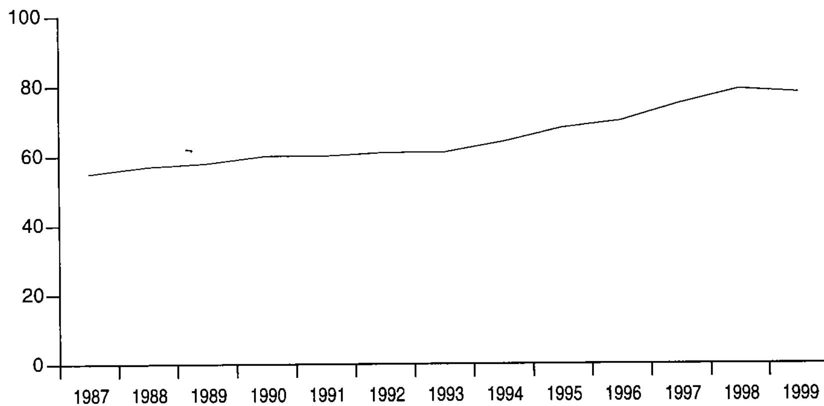
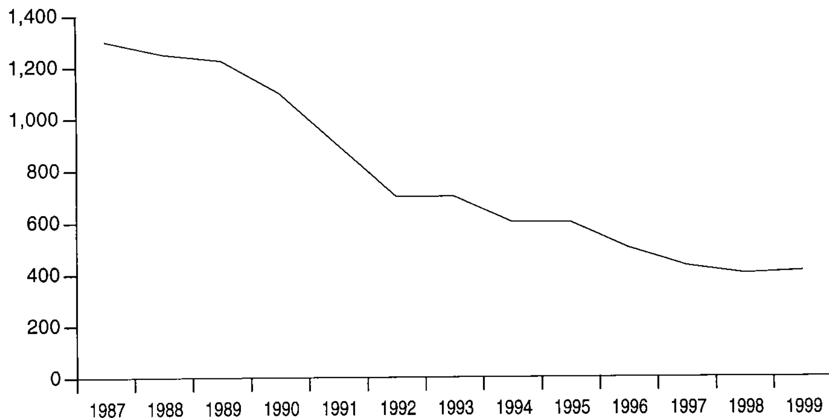


Figure 2 Units Built (thousands)



the top end of the qualified professionals group.

The reason for such high rates and short terms was that the mortgage credit market is not isolated from the rest of the domestic credit market. Rates and terms of mortgage loans, on the whole, reflect market values. In general, market interest rates are determined by the cost of the borrowed funds (interest paid on deposits). The latter is very high in Russia. Even now, the interest rate for one year deposit made in U.S. dollars is about 12%, and two years ago it was about 18%.[2]

In order to have lower rates and longer terms, one must create an environment that will provide mortgage lenders in Russia with funds cheaper and longer in term than that available through average deposits. This problem is solved in many countries with the help of alternative mortgage systems. The need for such a system in Russia became absolutely evident in the beginning of the 1990s.

Since there was no mortgage finance in the country, there were no local mortgage specialists. Because of that Russia was compelled to rely on foreign expertise. Several groups of foreign (mostly American) consultants were involved in developing a mortgage system for Russia. They worked independently, probably unknown to each other. But the basic idea developed by all these groups was the same–establishing a Russian copy of the American secondary mortgage market system.

Key to the development of the secondary mortgage market in the U.S. was the creation of three secondary market agencies, whose principal objective was to buy mortgage loans from banks and sell their own securities by packaging the loans. Two of these agencies are government-sponsored enterprises, (or GSEs)—Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation). Fannie Mae is the biggest and most widely known. Ginnie Mae (Government National Mortgage Association) is an agency of the U.S. government.

USAID (United States Agency for International Development) financed several projects related to the design of a mortgage system for Russia, beginning in the 1990s. As a result of this work, the general concept of establishing a secondary mortgage market was approved by the Russian government in1993, and the first Fannie Mae-type agency—the Russian Federal Agency for Housing Mortgage Lending (AHML)—was

founded in August 1996. About US$10 million was disbursed from the Russian federal budget to AHML in 1997. It was supposed to be enough for approximately 500 mortgage loans. The agency bought no loans until 1999 when it purchased five loans for the total amount of US$80,180.

The next effort was made by a group of American consultants from Harvard University hired in 1997 by the mayor's office of Moscow (the biggest Russian city with population of more than 10 million). They were supposed to develop a mortgage system for the city since the federal one did not work. The result of the work of these consultants was predictable. A secondary mortgage market system was recommended for Moscow. The city government approved the concept in August 1998, and a few months later the key element of the system, the Moscow Mortgage Agency (MMA), was established. In spite of having fewer resources, MMA was more active. In several months it bought 17 mortgages and then ran out of money and ceased its operations.

Yet a third program, "Your Family's House," sponsored by the U.S. Congress together with the Russian Duma, was launched to establish a mortgage system in Russia and provide to each Russian an opportunity to buy a home. The recommended scheme, of course, was a secondary mortgage market, and in order to put it into reality a third mortgage agency–Russian Mortgage Association (RMA)—was created. It appears that not even one mortgage loan was bought by RMA.

The basic ideas of all the schemes were so similar to each other that it even provoked a scandal. The Harvard group was accused of stealing the concept from the RMA group. Since there were no major differences in concept, we can discuss the idea of establishing a secondary mortgage market in Russia in general, why it did not work in Russia (unlike the U.S.), and what can be recommended instead.

How Does It Work in the U.S.?

Although the secondary mortgage market system of the U.S. has its critics, it does perform the task that was envisioned for the Russian mortgage system. The U.S. system provides mortgage lenders with funds that are cheaper and for longer terms than would be the case if lenders had to rely on deposits as the sole funding source. Mortgage loans are thus affordable to most Americans. A huge demand for housing has resulted in the growth of the housing construction industry and the massive production of homes. Home ownership has become a part of the American way of life.

The secondary mortgage market system was created in 1938, when Fannie Mae was established. It was a government-owned corporation designed to purchase mortgages that had been provided to low- and middle-income households, insured by the Federal Housing Administration (FHA). For a long time, the scale of operations of Fannie Mae remained quite modest. By 1968, its mortgage portfolio amounted to only US$7 billion, or a little more than 2.5% of the whole mortgage market.

In 1968 Fannie Mae was split into two structures: Ginnie Mae, which retained the status of a government agency, and Fannie Mae which, like Freddie Mac (established in 1970), got a semi-government status. They became government-controlled, joint-stock companies with the purpose of making a secondary market in loans provided to low- and moderate-income households.[3] Since their creation the scope of activity of Fannie Mae and Freddie Mac has widened—they may now buy individual loans that are about 40% greater than the cost of an average house.

The American scheme of reducing interest rates on mortgages works in the following way. A bank originates a mortgage loan, then sells the loan, secured by the house, to one of the GSEs. The GSE immediately pays the bank the entire amount of the loan and, in exchange, the bank services the loan and transfers to the agency the payments received every month from the homebuyer (mortgagor), minus the bank's margin.[4]

Thus, mortgage interest rates charged by a U.S. bank to a borrower (mortgagor) turn out not to be related either to interest rates on other non-mortgage loans originated by the bank, or to the cost of deposits (interest on deposits). What actually determines mortgage rates is the interest rate at which mortgages are purchased from the bank by the GSEs.

What determines the rate of the GSEs? Before the late 1960s, the source of their funds was the U.S. Treasury, so in effect mortgage rates were determined by the federal government.

Since 1970, when Ginnie Mae issued the first mortgage-backed security, the situation has changed. The secondary mortgage market actually transformed itself into a tertiary mortgage market, which now determines the cost of mortgage loans.

After buying mortgage loans from lenders, the GSEs pool them together and, on the basis of each pool, issue a new security, called a mortgage-backed security or MBS. Payments to MBS buyers are funded by mortgagors through repayments of their mortgage loans. The GSEs sell MBS on the open market, after which they also act as intermediaries, transferring the payments due to the GSE from the bank to the investor withholding their guarantee fee.

Thus, the interest rate at which the GSEs buy mortgage loans is based on the interest rate on their own securities. The rates on these securities are relatively low. They are

lower than the rates on the debt of institutions having the highest reliability (rated AAA) and only slightly higher than the rates on the U.S. Treasury Bonds.

Investors accept lower yields on MBS because the collateral is tied not to the fortunes of mortgagors, but to the liabilities of the GSEs deemed by investors to be backed by the government. The investors are sure that no matter how bad the mortgagors' default rate is, the GSEs will honor their commitments to investors, with the help of the U.S. Treasury, if necessary. Thus, the market treats the GSE securities as practically risk-free and qualifies them as investments suitable for the most conservative investors, such as pension funds and life insurance companies. Institutional investors hold long-term savings that can't be rapidly withdrawn (unlike the savings from commercial banks) which helps ensure the continued flow of long-term money into the mortgage market.

The long-term savings of U.S. citizens held by life insurance companies and pension funds are a major source of funds for long-term mortgage loans in the U.S. The reason these institutions invest in the sometimes-risky mortgage business and accept relatively low yields is because these investments are presumed to be guaranteed by the U.S. government, for all practical purposes.

How Can Such a System Work in Russia?

Establishing one or several mortgage agencies in Russia and providing them with starting capital from Russian or American governments has never been the problem. Rather, the problem is to find investors who would be ready to buy long-term securities of these agencies at relatively low interest rates.

Institutions that collect long-term, non-withdrawal savings and that could buy MBS virtually do not exist in Russia. The government pension fund does not make any investments. Non-government pension funds are very small. Only 2 million Russians (a bit more than 1% of the population) participate in non-governmental pension programs. In 1999 these funds provided pensions to only 181,000 Russian citizens with an average pension of about US$6.5 a month. The total sum taken in by all of the funds in 1999 is the equivalent of approximately 1.9 billion rubles (approximately US$75 million). Even if these funds were required to invest all the money they invest now in government securities (20% of all the assets) in government-guaranteed MBS, it would amount to only US$15 million a year.

The situation with life insurance companies is more complicated. The problem is that in Russia, life insurance is considered long-term even if it is for only one year. Most insurance is used as a semi-legal scheme of making payments without taxation. Money received as insurance coverage is exempt from taxes that an employer and an employee should otherwise pay. Because of that, instead of paying high salaries, many companies buy one-year life insurance certificates for employees. At the end of the year, an employee receives an addition to his salary without taxation.

Analyses show that these and similar schemes represent not less than 80% of the total sum of life insurance in Russia. Total annual long-term life insurance premiums collected in Russia are equal to approximately US$200 million. If we consider that real long-term life insurance comprises 20% of total life insurance funds and that one-fifth of that sum might be used to buy MBS, we will have only about US$8 million available.

Thus, since there are hardly any institutional investors in Russia, the only chance to establish a secondary mortgage market is to make it based on selling MBS to foreign investors. What foreign investors will buy them and what yield will they require from such securities?

Like the MBS in the U.S., these securities are going to be viewed by investors as government-guaranteed. Since they will be guaranteed by the Russian government, the rate on them will depend on Russia's credit rating and will be close to the rates on Russia's government debt—European bonds issued by the Russian Federation. Currently investors buying these securities require a return of about 15% annually. Thus, mortgage interest rates for a mortgagor counting on margin for a bank and an agency would have to be at least 20% in hard currency and about 30% in local currency. For mortgage loan borrowers, such an interest rate is unaffordable.

There are hopes that Russia's credit rating may increase, reducing the return required on Russia's government-guaranteed securities to about 10%. In this case, the interest for a mortgagor will be reduced to approximately 15%. Unfortunately, the possible reduction of interest rates does not solve the problem.

Interest on Russia's MBS sold on the international market will be tied to Russia's credit rating and Russia (unfortunately) cannot regulate that. A Russian agency buying mortgage loans for securitization would not know in advance what interest rate will be demanded by investors by the time the agency acquires enough mortgages to make up a mortgage loan pool for sale.

Thus, even if Russia's credit rating has improved by the time the secondary mortgage market is established, it is highly unlikely that the system would survive. Should the agency buy a pool of loans with a view toward selling securities at, say, 10%, investors might, due to a real or prospective drop of Russia's credit rating, only agree to

purchase securities from this pool at least at 12%. If that happens, the agency would have to default. Such a scenario is more than possible.

The conclusion is that the only chance to establish the secondary mortgage market in Russia is to find investors who will not require return on investments commensurate to their risk, i.e., they must agree to have modest return on investment with the risk that normally requires a high return. Such investors exist in the world. They are international financial organizations and institutional investors established by several governments in order to promote market reforms in Russia. The major purpose of their work is not to get high profit but to fulfill "the task." In most cases, the only source of finance for these investors are donations from governments, i.e., from these countries' taxpayers. It seems that the designers of a secondary mortgage system for Russia put the hope on these investors.

And this hope was not in vain. One of such group of investors, The US-Russia Investment Fund (TUSRIF), has begun to operate as a Russian mortgage agency, buying mortgages from local commercial banks. The secondary mortgage system based on TUSRIF funds is working. The interest rate on mortgage loans in banks working with TUSRIF is 10% to 18%, while interest on mortgage loans provided by banks that use deposits as a source of funds is 25% to 28%.

TUSRIF recently announced that it would use US$100 million to provide mortgage loans to Russians. This sum will be enough for approximately 5,000 loans. TUSRIF is a private institution, but its resources are made up entirely of money from a U.S. government grant. So cheap mortgages for approximately 5,000 highly paid Russian qualified professionals are provided now by American taxpayers via TUSRIF.

What will happen after the money allocated by TUSRIF is gone? Perhaps more money will be provided by American taxpayers. There are negotiations about an allocation from the U.S. budget for as much as US$2 billion for RMA to buy loans. If that happens, American taxpayers will help to provide cheap housing for approximately 100,000 Russian families. And what will happen after that? Either the mortgage system in Russia collapses, since it has no further source of funds, or another gift will come from American taxpayers. Taking into account that those professionals able to repay mortgage loans are rich by Russian standards, we are coming to an interesting conclusion. The mortgage system designed for Russia is a system that provides rich Russians with cheap loans, courtesy of foreign (mostly American) taxpayers. This is the way the system (with the help of TUSRIF) works now. This is the only way the secondary mortgage market can work until local pension funds and life insurance companies develop and become interested in buying securities of Russian mortgage agencies at relatively low interest rates (not more than 10% annually). The latter may happen only when interest on Russian government securities becomes lower and remains stable. Who knows when this will be?

In the meantime, mortgage funds in Russia are being provided by the U.S. government, that is, American taxpayers. Such a system is bad not only for Americans but for Russians as well. One can't rely forever on foreign taxpayers for one's own mortgage loans. Foreign assistance may provide help in creating a local system, based on local resources, but cannot provide sufficient resources for the market.

Is it possible to create a system based on local resources? It seems that the answer is yes. Mortgage finance existed in all countries a long time before domestic or foreign institutional investors became a reality. The so-called traditional mortgage model was used. Unlike the secondary mortgage model, the traditional model relies on deposits as the primary funding source. In its common form, it is also unacceptable for Russia because of the high cost of deposits, but it has a specific form, appropriate for such circumstances. It is so-called contract savings (closed) system.

Contract Savings (Closed) System

The major idea of the contract savings system is to raise cheap long-term resources for cheap mortgage loans by creating a closed (isolated) mortgage system, where the cost of money is independent from the financial market of the country as a whole. The isolated closed market is made up of specialized institutions–contract savings banks.

Such institutions are able to provide loans at rates below market, since they, in turn, raise funds at rates below market. The depositors and borrowers of contract savings banks (like depositors and borrowers in credit unions) are the same people—members (and in most cases owners) of the banks. For each of them, low deposit profitability is perceived as a fee for the right to get a mortgage loan at a low rate.

The practical implementation of the system in various countries and in different periods of time was different. But in all cases, it began with the same idea: "the borrower is a former depositor, and the depositor will be a borrower in the future." Contract savings began at a time when, in many countries of the world, like in Russia now, banks provided loans only at high rates and for a short term. People who wanted loans to buy a house could rely only on cooperation with friends who provided money to each other. Because of that, most contract savings banks began as cooperative developments.

The interaction of a contract savings bank with a prospective homebuyer occurred in two phases: the accumulation phase and the lending phase. During the accumulation phase, the depositor/member of the bank deposited money in even monthly installments for some period of time, receiving interest at the stipulated low rate.

The lending phase started when the bank member accumulated about half of the sum needed to buy a house. At this point, the member received the amount accumulated and an equal amount as a loan. The money for the loan was borrowed from the members of the contract savings bank who were still in the accumulating stage at that time. With this money, the bank member bought a home, registered its mortgage and started repaying the loan, returning money to the fellow members. Because of the low interest rate, the monthly loan payments were just slightly higher than monthly deposits had been and had no relation to the average rate on the market.

Mortgage institutions of this type still exist in Germany and Austria. They are known there as Bausparkassen.

This system, although in a rather specific form, played a great role in establishing mortgage financing in the U.S. It was the system of thrifts—S&L associations and mutual saving banks. Why has this system not been recommended for Russia?

Why Contract Savings Was Not Recommended for Russia

The reason none of the American consulting groups recommended a contract savings system for Russia was that the American S&L system endured huge crises just when Russia was looking for alternatives to the old system. In 1990, the U.S. General Accounting Office estimated that losses in this crisis exceeded $325 billion—over $1,000 for each resident of the U.S. American consultants could not recommend to anybody a system in such disrepute at home.

However, the S&L debacle should not be used as proof of the closed contract savings system deficiency, for by the time of its collapse the S&L system was not a closed type system.

This was not always the case. At the end of the 19th and beginning of the 20th century, the S&L system was a typical contract savings system. Nearly all S&Ls were mutual associations owned by depositors. Loans were at low interest, but for a short period of time (adequate to the period of saving), usually not more than five years. All depositors and borrowers were neighbors. It was forbidden by law to make loans on homes not located within 50 miles of an S&L home office.

At the beginning of the Great Depression, S&Ls got into serious trouble. Since depositors could withdraw money only at substantial cost, S&Ls experienced no runs, but the number of new depositors fell. Also, S&Ls had few or no retained earnings to cover losses due to mortgage default. States often did not require S&Ls to maintain minimum reserves of capital, and some states forced S&Ls to distribute all earnings.

In this situation the government decided to "open" the "closed" system by providing to all S&Ls an opportunity to borrow on preferential rates on the capital market and to attract depositors not interested in receiving mortgage loans. To accomplish the first task, according to Starbuck (see bibliography), "Congress created 12 regional Federal Home Loan Banks (FHLBs) in 1932 which were supposed to keep S&Ls liquid by judiciously advancing funds. Two years later, [the second task was accomplished] when the government created the Federal Savings and Loan Insurance Corporation (FSLIC) to insure S&Ls' deposits."

The character of the S&L associations was fundamentally altered. They were no longer closed institutions. The relationship in which "the borrower is a former depositor, and the depositor will be a borrower in the future" was broken. People deposited money in S&Ls as a safe government-guaranteed institution, not necessarily to get a mortgage loan. Since then, the difference in operation between S&Ls and traditional institutions of closed type grew greater and greater.

By the mid-1980s, the S&L system has been transformed into a system of organizations having nothing in common any more with contract savings (closed) organizations. Only 28% remained depositor-owned—72% became joint-stock companies. Besides making mortgage loans, they were allowed to invest in other assets.[5] S&Ls also acquired several deposits options (all guaranteed by the FSLIC).[6] They got the right to make loans and to attract deposits not only in their locality, but also throughout the U.S.

Actually, they turned into commercial banks with some peculiarities. These peculiarities were the ability to make non-mortgage loans (without the necessary expertise), low capital reserves, advantageous "regulatory accounting principles" and the ability to borrow in the capital market at preferential rates through the FHLBanks. Their collapse had nothing to do with the contractual savings system and demonstrated only the inefficiency of providing preferential regulations on an exceptional basis to some commercial banks.

Not Ideal, But a Better Alternative

A contract savings system has several advantages that are very important for current Russia. One of them is that the system is transparent. Contract savings institutions may not carry out any business except the issuance of mortgage loans to their mem-

bers. Thus, unlike a commercial bank depositor who has not the slightest idea about how, for which purpose and at what risk his money is used, a contract savings bank's depositor knows exactly who, and subject to what conditions, is using his money. After the huge banking crises of 1998, in which practically everyone who kept money in a bank partly or completely lost his savings, this advantage is a major one.

Another advantage relates to the specifics of Russian legislation which makes eviction of a defaulted borrower (mortgagor) very complicated. There is a special law, "The Law on Mortgage" of 1998, which regulates evictions. But there is no court practice, and some believe that in several cases the law may contradict several other laws. It will take some time before eviction will become a routine procedure.

In case of a contract savings bank's loan foreclosure, this problem is easier to solve than in case of foreclosure of a commercial bank's loan. Should any member of a contract savings bank (borrower) in default decide to take advantage of a loophole in the law and try to stay in the mortgaged house, he will have to deal not only with the court but with other depositors/members of the bank. They will view the person in default—a person living in their community—as trying to steal money from the others.

The third advantage is related to complications of underwriting in Russia. Russians have no credit history and do not register most of their earnings. In this situation, regular monthly depositing of money in the amounts approximately equal to the future monthly loan repayments through a substantial period of time may be used as an additional (or even a major) confirmation of creditworthiness of the client. It does not mean, however, that the contract savings model is an ideal.

First of all, the system is not very convenient. Contrary to the system used now in the U.S., a person can't receive a loan shortly after request. In the case of the contract savings system, he must save money first and for a rather long time—approximately equal to the period of the loan repayment. Actually, this system is only two times more convenient than saving money under mattresses and paying for a house in a lump sum. Instead of saving for 10 years, the person receives an opportunity to save during five years, then buy a house and then repay the loan in five years.

People agree to these conditions only in countries where the situation is similar to the one we have in Russia now; where demand for housing loans is very high while sources of acceptable funds practically do not exist. With the improvement and stabilization of the economic situation in a country, other housing loan opportunities are becoming more and more preferable to people. Contract savings institutions gradually start to lose their clients and either change their nature or disappear.

Only two countries with stable economies and well-developed financial systems–Germany and Austria—are keeping contract savings systems (Bausparkasse system) alive. The Bausparkasse system is able to compete with more convenient systems only because it has government support in the form of subsidy. Even with the subsidy, Bausparkasse loans do not play an important role and are used mostly as supplement loans or loans for renovation.

To some extent, usage of this system is, perforce, a temporary decision. It should be clear that along with institutional investor development and stabilization of the rate on Russia's debt, it will be gradually accompanied, and partly substituted, by the more convenient and modern secondary mortgage market system.

More than that, even as a temporary solution, the system has its handicaps, which complicates its establishment. But unlike the handicaps of secondary mortgage systems, these are comparatively easy to overcome.

The major problem of the closed mortgage system is fluctuations in deposits. The system works smoothly if the flow of depositors is constant, i.e., if the number of people starting to save is approximately equal to the number of people receiving loans. If the number of depositors shrinks for a while, the institution can survive only if it has enough capital reserves (equity) or has support from outside–ability to receive short-term financing from a special liquidity facility.

The shortages may happen in case of a substantial rise of market interest rates, as it happened in the U.S. at the end of the 1970s and beginning of the 1980s. In this case, the contractual savers stop making their low-profit deposits in order to invest money in profitable market assets, even if this means losing the option of a cheap mortgage loan. But this may happen only, as it did in the U.S., "if alternative investments paying market rates [are] available. [In the U.S.] money market mutual funds were such an investment," according to Weicher (see Bibliography).

In Russia there are practically no opportunities for alternative investments now. After the financial crises, most Russians became strongly distrustful of any financial institutions promising high yield on investments. Only two types of financial institutions remain that people trust: government banks and banks guaranteed by reliable foreign financial institutions.

There is one government bank in the country that works with private savers—Sberbank. Its share of private savings increased after the recent crises from 45% to 85%. The banks established and guaranteed by well-known foreign financial institutions started to

accept private deposits only after the crises. They have such a high inflow of deposits that they were compelled to put restrictions on savings. None of them accepts savings in an amount less than $5,000–more than six times an average annual salary.[7]

Other financial institutions have not succeeded in attracting deposits even with high interest rates. Thus, if contract savings institutions are established as specialized banks guaranteed by the government or by foreign organizations, they will on one hand have little risk of shrinkage of inflows and on the other hand will be able to use a guarantor as a liquidity facility.

It should be mentioned that during the period of establishing and expanding of a contractual savings system, the number of savers and, hence, the liquidity of the system is growing. In this period the guarantor (in most cases the government) bears practically no risk. The situation is the opposite as the system matures or declines. At that time, a liquidity facility should provide financial support for the system.

The decline starts when alternative investments become available for savers which, in turn, provide alternative sources of funds for housing loans. This is the period when the economic situation of the country becomes more stable and its financial system becomes better developed. At this period of time, the government should be strong enough to provide support for painless extinction of the contract savings system. Depending on the pace of the country's development, the extinction may take a rather long time. But in any case, this problem proceeds in parallel with improvement of economic conditions in a country, which makes the problem solvable.

The second problem concerns the situation which may happen in a recession, when wages fall and borrowers cannot then repay their loans. In this case, an increasing amount of foreclosures will be accompanied by declining real estate value, making it impossible for banks to compensate by selling the collateral.[8] This risk in an unstable Russian economy is very serious. But the same may be said for all kinds of mortgage systems. So this risk should not prevent the establishment of a contract savings system. At the same time, the absence of a mortgage system makes the economy even more vulnerable to recession, due to the decrease of housing demand and the resulting increase in unemployment in the construction industry.

It should be mentioned that a contract savings system is more vulnerable to inflation than all other housing finance systems. Starting his accumulation period, a saver knows the particular amount of loan he will be authorized when the savings period is over. According to his expectations, this sum together with his savings should be enough to buy a house he wants. In fact, as a result of unexpected inflation by the end of the accumulation period the house may become unaffordable if housing prices increase.

It is interesting that this particular weakness of a contract savings system demonstrates one of its advantages for current Russia. For the major part of the population, the only alternative that exists now to a contract savings system is saving money under a mattress. In this case, it takes twice as long to save the money and the borrower still has the risk of home prices increasing.

The third problem is that domestic law does not now provide for any special form of credit institution operating under a contract savings scheme. No such specialized bank is mentioned in Russian banking law. This structure cannot be established as a department of a commercial bank, for there is no guarantee that the funds provided by investors will not be used for other purposes. The reason this problem is not resolved yet is because the authorities responsible for designing a mortgage system in Russia are focused on the secondary market model.

For example "Conceptual Basis for the Development of the System of Residential Mortgage Lending," adopted by the government in January 2000. The section related to "Attracting credit sources to long-term mortgage lending" does not even mention long-term savings in contract savings institutions as a potential funding source. Instead, it puts a great emphasis on issuing mortgage securities and further developing the system of loan refinancing.

According to Presidential Decree #28, dated January 11, 2000, the secondary market concept is a basis for developing regional programs of long-term housing finance. It means that Russian regions are doomed to continue the fruitless efforts of Moscow to arrange a secondary mortgage market. Several regional mortgage agencies have been set up already. The effectiveness of spending time and money on these establishments is easy to predict.

No one can continue to repeat the same mistake forever. At some point in time, attitudes will have to change and allow for development of a contract savings system. The only question is when.

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NOTES

[1] A slight increase occurred in 1999 when 414,000 units were built. The reason was the dramatic reduction of housing construction cost at the end of 1998 as a result of the financial crises and expectations of legislative changes in 2000.

[2] At the beginning of the year 2000, interest rates on mortgage loans issued by banks using deposits as a financial source were 25% to 28% in U.S. dollars and 37% to 42% in local currency (ruble). [See Notes #7.]

[3] The semi-government status of the two GSEs derives from government regulation of their activity (five out of 18 members of the board of directors of each are nominated by the U.S. president), the ability to borrow up to $2.25 billion in an emergency from the U.S. Treasury, exemption from state and local income taxation and from registration and reporting requirements of the Securities and Exchange Commission, designation of their securities as "government securities" for purposes of the Securities Exchange Act of 1934 and the Federal Reserve Act, etc. [See Notes #4.]

[4] Actually, the scheme is much more complicated since loans are often underwritten, originated and serviced by different institutions.

[5] There were the following assets: commercial, corporate, business or agricultural loans (10%), consumer loans (30%), loans secured by non-residential real estate (40%) and personal property (10%). In 1990 non-mortgage assets comprised 40% of their total assets. [See Notes #1.]

[6] The options included interest-bearing checking accounts, short-term money market certificates, small savers' accounts and (from 1980) Negotiated Order of Withdrawal (NOW) accounts to individuals and not-for-profit organizations.

[7] An equivalent requirement for the U.S. would be to keep a minimum of US$250,000 in a savings account.

[8] This situation was in Texas in the middle of the 1980s after the decline of domestic oil prices. The result of growing insolvency of depositors combined with decline of real estate values, which fell by one-third, was the massive collapse of mortgage financial institutions. "One-fifth of the S&Ls which failed during the 1980s were located in Texas and they accounted for half of the losses." [See Notes #6.]